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### The SEC or The Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets

David A. Lipton

*The Catholic University of America, Columbus School of Law*

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# The SEC or the Exchanges: Who Should Do What and When? A Proposal to Allocate Regulatory Responsibilities for Securities Markets

BY DAVID A. LIPTON\*

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\* Associate Professor of Law, Catholic University of America, Columbus School of Law; B.A., Cornell University, 1966; M.A., Columbia University, 1968; J.D., University of Michigan, 1972. Professor Lipton would like to express his appreciation for the editorial contributions of his research assistant, Anthony J. Colucci, III.

## INTRODUCTION

Our national securities markets<sup>1</sup> are supervised by a process characteristically described as "self-regulatory oversight."<sup>2</sup> This phrase connotes a statutory relationship between the self-regulatory organizations (SROs) and the Securities Exchange Commission (SEC).<sup>3</sup> Under a commonly held perception of this relationship, the exchanges and the National Association of Securities Dealers (NASD) supervise their respective markets while the Commission asserts its reserve power only if the SROs' initial exercise of authority is inadequate.<sup>4</sup> An early chairman of the SEC, and later Supreme Court Justice, William O. Douglas, provided what has become a widely quoted description of how the self-regulatory oversight system is seen to operate. Justice Douglas said that under self-regulation

[T]he exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.<sup>5</sup>

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<sup>1</sup> The term "securities markets" refers to both exchange and over-the-counter markets. The exchange markets are regulated by each exchange. The over-the-counter market is regulated by the only regulatory securities association, the National Association of Securities Dealers [hereafter NASD]. Both the exchanges and the NASD are referred to as self-regulatory organizations [hereafter SROs].

<sup>2</sup> This supervisory relationship was established by the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976 & Supp. V 1981) [hereafter 1934 Act]. In the hearings conducted on the 1934 Act, the relationship between the exchanges and the Commission was described as follows: "[T]he exchanges should be permitted or required to regulate themselves; but there should be Federal Authority holding the power which in a previous administration would have been referred to as 'a big stick.'" *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 544 (1934) (statement of Rep. Charles A. Wolverton) [hereafter 1934 House Hearing]. Nearly thirty years after adoption of the 1934 Act, the Securities and Exchange Commission described the regulation of exchanges as consisting of "not merely self-regulation, but self-regulation supervised by the Government." SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 502 (1963) [hereafter SPECIAL STUDY].

<sup>3</sup> Hereafter, also referred to as the Commission.

<sup>4</sup> In 1933, at President Roosevelt's direction, the Interdepartmental Committee on Stock Exchange Regulation (the "Roper Committee") was formed and laid the foundation for the 1934 Act's self-regulatory framework. John Dickinson, Assistant Secretary of Commerce and Chairman of the committee, envisioned the federal government as holding the powers to regulate exchanges in "reserve to see that [sic] self-regulation is exercised." 1934 House Hearing, note 2 *supra*, at 514.

<sup>5</sup> W. DOUGLAS, DEMOCRACY AND FINANCE 82 (1940) (speech delivered on May 20, 1938).

Although Justice Douglas' analogy presents a picturesque image of how self-regulatory oversight operates, the analogy is basically flawed. It is flawed in part because the SEC, even at its inception, was intended to play more than a residual role in the regulation of the securities market regulatory process. Moreover, the Commission's role since that time has been expanded, providing it with even greater direct responsibilities in regulating the securities markets.

Certainly, proponents of the Securities and Exchange Act of 1934 anticipated that the exchanges would be primarily responsible for their own day-to-day regulation.<sup>6</sup> It is also clear, however, that the Commission was authorized to determine that some matters would be supervised directly by the government instead of the exchanges.<sup>7</sup> Even former Chairman Douglas, in a statement cited less frequently than the familiar quote above, expressed "doubts" about the desirability of entrusting exchanges entirely with "actual regulation and enforcement within their own field."<sup>8</sup> He instead called for a "joint venture of the Commission and the exchanges" in assaulting certain undesirable practices of the securities markets.<sup>9</sup>

The Commission's market regulatory role, initially defined in 1934, has been expanded in the past two decades both through Commission practices and legislation. In the mid-1960s, responding to recommendations made in the SEC's Special Study of Securities Markets, the Commission began to assert more aggressively its "reserve" powers by seek-

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<sup>6</sup> Although John Dickerson recognized the shortcomings of self-regulation during the confirmation hearings preceding passage of the 1934 Act, he clearly favored exchange self-regulation:

In framing a regulatory measure the practical problem of administration has always to be faced and when regulation gets beyond a certain point the sheer ineffectiveness of attempting to exercise it directly through the government on a wide scale counterbalances the fact that possibly the exchanges might not be as diligent as we would wish them to be about regulating themselves or as diligent as the government would be if the task were compact enough to fall within the limits of effective government performance.

1934 House Hearing, note 2 *supra*, at 514.

<sup>7</sup> See notes 25-29 and accompanying text *infra*. Professor Loss referred to the original statutory scheme of the original 1934 Act as providing "the Commission considerable discretion in the matter of drawing the line between self-regulation by the exchanges and direct governmental supervision." 2 L. LOSS, SECURITIES REGULATION 1180 (2d ed. 1961).

<sup>8</sup> W. DOUGLAS, note 5 *supra*, at 64. This statement was released on November 23, 1937, six months prior to the "shotgun" speech.

<sup>9</sup> *Id.* at 66.

ing to correct certain market abuses.<sup>10</sup> Congress sanctioned this broadened regulatory role in the Securities Reform Act of 1975.<sup>11</sup> The Commission's direct market regulatory authority was not only expanded in the area of rulemaking and discipline, but it was also assigned entirely new responsibilities in moulding the structure of the newly mandated national market system.<sup>12</sup>

Thus, the SEC's current role in regulating the securities markets is not limited to mere oversight. Rather, the Commission also possesses power to initiate market regulations on most significant issues that fre-

<sup>10</sup> For a discussion of the development of the Commission's expanded use of authority, see Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663, 665-67 (1964) [hereafter Jennings]. SEC Chairman William L. Cary, who headed the Commission during the period of expansion, commented:

In sum, I do not agree that the Commission should have to resign itself to a vestigial role in dealing with an exchange and its members. I feel we must become directly involved, as we have in major disciplinary proceedings involving exchange members, where important questions of principle are at stake.

Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244, 246 (1963).

<sup>11</sup> Securities Reform Act of 1975, Pub. L. No. 94-29, 89 Stat. 97. "The 1975 Act provided a radical increase in the powers of the Commission over the rules of the self-regulatory organizations." N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS 12-22 (1973) [hereafter N. WOLFSON]. The 1975 Amendments were the outgrowth of both recommendations made twelve years earlier in SPECIAL STUDY, note 2 *supra*, and two extensive studies conducted by Congress in the early 1970s. See SUBCOMM. ON SECURITIES OF SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. DOC. NO. 13, 93d Cong., 1st Sess. (1973); SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. REP. NO. 1519, 92d Cong., 2d Sess. (1972).

For a general discussion of the expanded Commission authority resulting from this legislation, see N. WOLFSON, *supra*; Moylan, *The Place of Self-Regulation in the Securities Industry*, 6 SEC. REG. L.J. 49, 53-58 (1978).

<sup>12</sup> In the legislative history of the 1975 Amendments, Congress expressed the expectation that:

[T]he SEC would be expected to play a much larger [regulatory] role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need and, when appropriate, to provide leadership for the development of a more coherent and rational regulatory structure to correspond to and to police effectively the new national market system.

SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT TO ACCOMPANY S. 249, S. REP. NO. 75, 94th Cong., 1st Sess. 2 (1975) [hereafter 1975 SENATE REPORT].

quently "overlap" the power of the SROs.<sup>13</sup> This overlapping authority affords the Commission an opportunity to respond to market regulatory concerns in several different ways. The SEC can allow the SROs to deal directly with regulatory concerns and thus involve itself in a traditional oversight capacity. Alternatively, in many instances, the Commission may choose to be the initiating regulatory body, using its direct or indirect authority to effect its will.

This article will investigate what principles should guide the Commission in allocating decision making authority over regulatory matters between itself and the SROs. When should the SEC initiate the resolution of issues? When should it merely oversee the efforts of the SROs in issue resolution? Finally, can specific market regulatory problems be analyzed pursuant to these principles to determine how decision making authority should be allocated? In addition to providing a model for answering these questions, the guidelines<sup>14</sup> developed in this article will also have relevance to the broader question of allocating decision making responsibility between the government and the private sector.

## I. CATEGORIES OF COMMISSION AUTHORITY

Before discussing how decision making authority should be allocated between the Commission and the SROs, it is necessary to analyze the nature of the Commission's authority to regulate the securities markets and then to examine the areas in which this authority overlaps that of the SROs. For purposes of analysis, we may divide the Commission's market regulatory authority into three broad categories: response, direct, and indirect control.

### A. *Response or Pure Oversight Control*

This is the classic oversight authority,<sup>15</sup> exercised only in those instances in which the Commission is authorized to approve or disapprove action already taken by an SRO. For example, under Section 19(e) of the 1934 Act, the Commission is authorized to review discipli-

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<sup>13</sup> This joint authority was characterized in the legislative history of the 1975 Amendments as "mutual regulatory responsibil[ity]" with the ultimate authority (perhaps only oversight authority) resting with the Commission. 1975 SENATE REPORT, note 12 *supra*, at 23.

<sup>14</sup> These guidelines are not intended to be exclusive, but rather, to be suggestive of subsequent models of allocating decision making.

<sup>15</sup> Although "response" authority is typically referred to as "oversight" authority, oversight is a broader concept which includes all categories of the Commission's regulatory authority over SROs.

nary sanctions imposed by the SROs against respective members.<sup>16</sup> This authority is activated only if the SRO sanctions a member pursuant to the rules of the SRO. Under Section 19(e), the Commission may affirm the sanctions after determining that: (i) the disciplined person has committed the acts for which he is sanctioned; (ii) that such acts violate the 1934 Act, its rules or regulations or the rules of the self-regulatory organization; and (iii) that the sanctions are consistent with the purposes of the 1934 Act.<sup>17</sup> When the Commission affirms the existence of a violation, it may still modify the sanction if it is found to impose a burden on competition or if it is excessive or oppressive.<sup>18</sup> Alternatively, the Commission may not make such a finding and in such a case must then set aside the sanction and, if it chooses, remand the matter to the SRO.<sup>19</sup> This review by the SEC may be initiated on its own motion or upon request of a party subject to the disciplinary action.<sup>20</sup> In either instance, as with any Commission response authority, there must be an initial action (here, a disciplinary sanction) taken by an SRO, to which the Commission responds.

Of course, the Commission has response authority in areas other than review of SRO discipline of its members. These include its power to discipline SROs either for noncompliance with the 1934 Act, its rules and regulations, for violation of the SRO's own rules, or for an SRO's failure to enforce member compliance with any of these provisions.<sup>21</sup> The Commission's response authority also includes power to review SRO proposed rule changes.<sup>22</sup>

Much of the Commission's response authority today represents a significant augmentation of the mandate that the Commission possessed prior to 1975. For example, prior to the 1975 Amendments, the Commission exercised disciplinary review power only in respect to NASD actions, not disciplinary actions taken by the exchanges.<sup>23</sup>

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<sup>16</sup> 15 U.S.C. § 78s(e) (1976).

<sup>17</sup> *Id.*

<sup>18</sup> 15 U.S.C. § 78s(e)(2) (1976). The Supreme Court specifically suggested the need for SEC review of exchange imposed sanctions because of their impact upon competition. *Silver v. New York Stock Exch.*, 373 U.S. 341, 359 (1963). Prior to 1975, no such basis existed for reviewing exchange imposed sanctions.

<sup>19</sup> Securities Exchange Act of 1934, § 19(e)(1)(B), 15 U.S.C. § 78s(e)(1)(B) (1976).

<sup>20</sup> *Id.* § 19(d)(2), 15 U.S.C. § 78a(d)(2) (1976 & Supp. V 1981).

<sup>21</sup> *Id.* § 19(h)(1), 15 U.S.C. § 78s(h)(1) (1976).

<sup>22</sup> *Id.* § 19(b), 15 U.S.C. § 78s(b) (1976).

<sup>23</sup> Former Act § 15A(f) and (g) provided the Commission with this review authority for the NASD prior to 1975. 15 U.S.C. § 78o-3(f) and (g) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)). In 1963, the Special Study recommended a reexamination of the reasons for discrepancies between the Commission's powers over the ex-

The review procedure of SRO proposed rule changes also represents a significant increase in the response powers of the Commission. Before 1975, neither solicitation of public comment, nor filing by the SRO of a justification for the proposed rule change, nor prior Commission approval of proposed changes, were required.<sup>24</sup> This expansion of response authority has increased the avenues available to the Commission for effecting specific policies, thus requiring further decision making by the Commission as to how to achieve its goals.

### B. Direct Control

The Commission also possesses authority to initiate its own resolution of specific concerns. Under its direct control authority it may effect goals without employing the channels of the SROs (although effective implementation of a Commission goal may well require SRO surveillance and enforcement).

The Commission's direct authority can be divided into two components: (i) authority to alter exchange rules without SRO involvement and (ii) authority to promulgate its own rules to directly control securities market activities.<sup>25</sup> For example, under the first category, pursuant to Section 19(c) of the 1934 Act, the Commission may "abrogate, add to, and delete from" the rules of a SRO. If the governing rules of a SRO do not comply with the Commission's vision of which subject matters should be covered or how these matters should be handled, the Commission, after notice and an opportunity for interested persons to be heard, may amend an exchange's or the NASD's own rules.<sup>26</sup> Under

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changes and the NASD. SPECIAL STUDY, note 2 *supra*, pt. 4, at 726-27.

<sup>24</sup> The prior act required only that an exchange furnish the Commission with a copy of any amendments to its rules. See former Securities Exchange Act of 1934, § 6(a)(4), 15 U.S.C. § 78f(a)(4) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)). Even when the NASD had to make a prior filing with the Commission before adopting rule changes, there was no mandated opportunity for public comment or any requirement of filing a jurisdiction for the rule. See former Securities Exchange Act of 1934, § 15(A)(j), 15 U.S.C. § 78o-3(j) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)). As a practical matter, the New York Stock Exchange would give the Commission prior notice of rule changes even before 1975. 11A Pt. 1 BUSINESS ORGANIZATIONS, SECURITIES REGULATION, FEDERAL SECURITIES EXCHANGE ACT OF 1934, 2-24 n.4 (E. Gadsby, ed.) (MB) (1980).

<sup>25</sup> These categories roughly correspond to a similar analysis found in the legislative history of the 1975 Amendments. 1975 SENATE REPORT, note 12 *supra*, at 131. However, the Senate Report included a third category which corresponded to what the text identifies as indirect authority. See notes 30-32 and accompanying text *infra*.

<sup>26</sup> Securities Exchange Act of 1934, § 19(c), 15 U.S.C. § 78s(c) (1976). It is important to note that statutory provisions granting the Commission direct authority, such as



the second category, the Commission may directly regulate securities market activities through its own rules. Thus, when the Commission restricts the price at which short sales may be effected, pursuant to Rule 10a-1,<sup>27</sup> it preempts this area of market regulation by direct action through its own rules.

As with the SEC's oversight authority, the 1975 Amendments significantly expanded the Commission's direct authority. For example, former Section 19(b) of the 1934 Act, the predecessor of present Section 19(c) (authorizing the Commission to amend SRO rules), limited the Commission's authority to alter exchange rules to twelve enumerated categories. Present Section 19(c) is not so limited. Within these twelve areas, the Commission could act only after making an "appropriate request in writing" to the exchange. Present Section 19(c) makes no such demand on the Commission. The Commission's authority under former Section 19(b) was more in the nature of oversight authority than direct authority. Also, since 1975 the Commission has had direct authority to enforce the rules of the SROs,<sup>28</sup> and is no longer hampered by SRO reluctance to pursue disciplinary problems. Prior to 1975, the Commis-

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§ 19c, do not require a showing by the Commission of attempts to have the SROs assume regulatory responsibility. The Commission's authority is original authority. In the past, the Commission's direct authority was not similarly unfettered. Former § 19(b) required the Commission to make a written request to a securities exchange that it effect a rule change before the Commission acted on its own to alter the exchange's rules.

<sup>27</sup> 17 C.F.R. § 240.10a-1 (1982).

<sup>28</sup> Section 21(d) of the 1934 Act allows the SEC to enjoin violations of the SROs' rules in federal district court. 15 U.S.C. § 78u(d) (1976). Prior to 1975, the SEC could seek injunctions only for violation of the 1934 Act or its own rules and regulations. See Securities Exchange Act of 1934, § 21(e), § 15 U.S.C. § 78u(e) (1970) (amended by Pub. L. No. 94-29, 89 Stat. 97 (1975)). The Commission's authority under § 21(d) is partially direct authority because the SEC may act if it determines that such action is "necessary or appropriate in the public interest or for the protection of investors." Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u(f) (1976). But, it is also oversight authority in part because the Commission's alternative reason for initiating a § 21(d) action would be the result of an SRO being "unable or unwilling to take appropriate action." *Id.*

In 1971, the SEC found its authority was often insufficient to ensure fair and effective self-regulation because the SEC could not directly enforce the rules of the SROs. See SECURITIES AND EXCHANGE COMMISSION, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. NO. 231, 92d Cong., 2d Sess. 41 (1971). The 1975 Amendments ameliorated this deficiency.

The 1975 Amendments also granted the Commission new authority to suspend or expel SRO members for violation of the Securities Acts and the Commission's own rules. Securities Exchange Act of 1939, § 19(h)(2), § 15 U.S.C. 78s(h)(1) 1976.

sion could enforce its own rules, but not those of an exchange. Again, this augmentation of direct authority of the Commission means that in more instances the Commission's authority and that of the SROs will overlap. Moreover, the Commission has multiple means of resolving specific problems because the 1975 Amendments have also increased its means of resolving issues.<sup>29</sup>

### C. Indirect Control

Finally, the Commission has authority to compel SROs to adopt rules for themselves. Under Rule 11b-1,<sup>30</sup> for example, the Commission has dictated for which matters, regarding specialists, exchanges must adopt rules.<sup>31</sup>

Although indirect control requires Commission initiation, it obviously also requires exchanges to undertake rulemaking action in response to the Commission's dictates.<sup>32</sup> The indirect authority approach allows the SEC to set broad guidelines, while leaving details to those who are closest to the issue, the SROs.

### D. Qualifications

The line dividing the categories of response, direct, and indirect control is not always clear. Although the Commission is usually initiating regulatory action when it utilizes its direct authority, this authority may also be employed in a response/oversight mode. Thus, if the Commission uses its Section 19(c) authority to amend an earlier promulgated SRO rule, the SEC is really responding (oversight action) to SRO regulatory actions as opposed to initiating its own action (direct action).

Alternatively, the Commission has also used its oversight authority to initiate certain Commission policies. Thus, when the Commission chose

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<sup>29</sup> The legislative history of the 1975 Amendments shows that the expansion of the SEC's direct authority was not meant to restrict its oversight authority. "Although Section 19(c) would give the SEC plenary power over self-regulatory rules, the section in no way limits the SEC's ability to use its other powers . . . ." 1975 SENATE REPORT, note 12 *supra*, at 131.

<sup>30</sup> 17 C.F.R. § 240.11b-1 (1982).

<sup>31</sup> See e.g., Rule 104, NEW YORK STOCK EXCHANGE, INC., CONSTITUTION AND RULES (CCH) ¶ 2104 (1981). The New York Stock Exchange adopted its Rule 104 to comply with the Commission's Rule 11b-1.

<sup>32</sup> The failure of an SRO to comply with the Commission's indirect authority may lead to disciplinary action. The sanctions range in severity from censure to revocation of registration. Securities Exchange Act of 1934, § 19(h)(1), 15 U.S.C. § 78s(h) (1976).

to create a liberal policy of granting unlisted trading privileges,<sup>33</sup> it was in the granting of the application (essentially a response action) that the Commission defined its policy for further applications (essentially an initiating action).

Similarly, an "informal" use of Commission authority can blur the boundaries between the various categories of authority. Rather than initiate its own rules or direct an SRO to adopt certain rules, the Commission has at times suggested to SROs that they adopt certain rules or initiate specific practices. When the SEC has the authority to adopt the requested rule or directly initiate the requested action were the SRO not to comply, the Commission's "suggestion" is a powerful request.<sup>34</sup> This informal use of direct authority, if effective in persuading a SRO to act, is most similar to indirect authority.

### *E. Classifying Market Regulatory Activities*

For convenience of analysis, the Commission's exercise of its several types of authority will be examined in terms of three broad areas of regulatory activities: (i) rulemaking and order granting; (ii) discipline; and (iii) policy setting. If defined with sufficient breadth, these three categories essentially cover all Commission activities in the field of market regulation. They are not intended to be mutually exclusive, but rather overlapping in part. Thus, rulemaking and order granting activity, in some instances, can also be policy setting activity. An example, as discussed above, is when the Commission wanted to set a liberal policy of granting unlisted trading privileges to regional exchanges<sup>35</sup> to

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<sup>33</sup> See Securities Exchange Act Rel. No. 16422 (Dec. 12, 1979), [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,657, 18 SEC DOCKET 1323 (Dec. 26, 1979). See notes 35-37 and accompanying text *infra*.

<sup>34</sup> See Jennings, note 10 *supra*, at 664 n.7 (Commission's implied threat of its direct authority for rulemaking encouraged the New York Stock Exchange to adopt its own rules regulating floor trading); Securities Exchange Act Rel. No. 7330 (1964); Kripke, *The SEC, Corporate Governance and the Real Issues*, 36 BUS. LAW. 173, 188-89 (1981) (analysis of Commission's pressure on exchanges to require listed companies to establish independent audit committees); Comment, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J. 811, 816-30 (1971) (discussing informal use of direct authority).

<sup>35</sup> See text accompanying note 33 *supra*. A "regional exchange" or "regional" is any national stock exchange other than the two exchanges in New York City. These include: the Boston Stock Exchange (BSE), Cincinnati Stock Exchange (CSE), Midwest Stock Exchange (MSE), Pacific Stock Exchange (PSE), and the Philadelphia Stock Exchange (PHLX). The two stock exchanges in New York City, the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) are referred to as the "primary exchanges." Major domestic corporations typically are listed on the primary

encourage competition between regional and primary exchanges (a policy setting activity).<sup>36</sup> It granted an order approving an omnibus application for unlisted trading privileges by a regional exchange (a rulemaking or order granting activity), and through the order described its liberal policy.<sup>37</sup>

Rulemaking and discipline may similarly be intertwined. The Commission will employ its disciplinary authority to enforce its rulemaking actions. Thus, failure of an exchange and brokerage firm to comply with the Commission's quote rule<sup>38</sup> (rulemaking activity), a rule considered central to the national market system,<sup>39</sup> has led to censure of both an exchange<sup>40</sup> and a brokerage house<sup>41</sup> (disciplining activity). Although these activities overlap, they are separate components in terms of analysis of Commission activity.

## II. EXTERNAL AND INTERNAL OVERLAP BETWEEN TYPES OF COMMISSION AUTHORITY

For the vast majority of issues of market regulatory concern, whether involving rulemaking and order granting, discipline or policy setting, the Commission has means of effecting its will through direct, indirect,

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stock exchanges, pursuant to §§ 12(a) and 12(b) of the 1934 Act, 15 U.S.C. § 78l(a) and (b) (1976). Often, these major corporations are not inclined to be listed on the regional exchanges. However, these corporations' securities can still be traded on the regional exchanges if the exchanges are granted "unlisted trading privileges" under Securities Exchange Act of 1934, § 12(f), 15 U.S.C. § 78(l) (1976).

<sup>36</sup> Securities Exchange Act Rel. No. 16422 (Dec. 12, 1979), [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,657, 18 SEC DOCKET 1323 (Dec. 26, 1979).

<sup>37</sup> The MSE applied for unlisted trading privileges in 910 companies with primary listings on the NYSE. The number of companies for which unlisted trading privileges were being sought was roughly one hundred times greater than the number for which requests had been made in any previous application. The size of this request compelled the Commission to spend more than two years examining its unlisted trading privileges policy. During that time no unlisted trading privileges were granted to any exchange.

<sup>38</sup> Rule 11Ac1-1, 17 C.F.R. § 240.11Ac13-1 (1982).

<sup>39</sup> See Lipton, *Best Execution: The National Market System's Missing Ingredient*, 57 NOTRE DAME LAW. 449, 458-60, 483-85 (1982) (discussing significance of quote rule to national market system).

<sup>40</sup> The PHLX was censured for violating the quote rule in failing to establish and maintain adequate procedures to collect, process, and make available reliable quotations from its members. Securities Exchange Act Rel. No. 16648 (Mar. 3, 1980), 19 SEC DOCKET 876 (Mar. 25, 1980).

<sup>41</sup> The SEC found Dean Witter Reynolds, Inc. in violation of the quote rule when, as a specialist on the PHLX, it failed to report quotations in certain securities. Securities Exchange Act Rel. No. 16808 (May 15, 1980), 20 SEC DOCKET 14 (May 27, 1980).

or response authority.<sup>42</sup> For every instance in which the Commission has this multiplicity of authority it can choose to either initiate a course of action to resolve a problem or respond to action initiated by an SRO to resolve a problem. If the Commission chooses to initiate action, it might use its direct, indirect, or in some cases, its response authority.<sup>43</sup> If the Commission chooses to respond to SRO action rather than initiate its own, it might use its response authority, or fail to respond (which may be viewed as a type of response).<sup>44</sup> Obviously, for every instance in which the SEC has response authority, the SROs have the authority to effect their will (at least until the SEC responds) through initiating action.<sup>45</sup> Thus, for many, if not most matters that fall under the purview of the SEC's authority, its authority and the authority of the SROs partly overlap.

Each time the Commission exercises its market regulatory authority it must decide, either explicitly or implicitly, how best to resolve an issue — whether to respond to regulatory activity or initiate it. If the Commission chooses to initiate the activity, it must also make a decision as to what type of initiating authority it should employ.

An example of the overlapping authority can be found in the area of

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<sup>42</sup> The SEC has no direct authority over some obvious market regulatory matters. For example, the SEC has no direct or indirect authority to file a registration application for an SRO or to adopt the initial rules of an SRO. Securities Exchange Act of 1934, § 6(a), 15 U.S.C. § 78f(a), (1976). *Id.* § 15A, 15 U.S.C. § 78o-3 (1976). Of course, the SEC has response authority to pass upon such applications. *Id.* § 19(a)(1), 15 U.S.C. § 78s(a)(1) (1976). The SEC has no direct authority to approve applications for membership to an exchange. *Id.* § 6(b)(2), 15 U.S.C. § 78f(b)(2) (1976). The SEC can, however, deny membership. *Id.* § 6(c)(2), 15 U.S.C. § 78f(c)(2) (1976). Moreover, the SEC can review the membership decision made by exchanges. *Id.* §§ 19(d)(1), 19(f), 15 U.S.C. §§ 78s(d)(1), 78s(f) (1976).

<sup>43</sup> When answering an application from an SRO, the Commission may use its response authority to indicate its future response to similar applications, thus setting a policy.

<sup>44</sup> Congress intends that for some regulatory matters no Commission response to SRO action is necessary. Thus, if an SRO files a rule change pursuant to § 19(b)(3)(A), which is intended only to interpret a present rule, establish or change a fee, or deal with internal administrative matters, the rule may become effective without any Commission approval. Securities Exchange Act of 1934, §§ 19(b)(1)(3)(A), 15 U.S.C. § 78s(b)(3)(A) (1976). The Commission has response authority to "abrogate" such SRO rule changes if it acts within 60 days of their filing. *Id.* § 19(b)(3)(C), 15 U.S.C. § 78s(b)(3)(C) (1976).

<sup>45</sup> As with the Commission, an SRO lacks formal initiating authority over some obvious matters. For example, only the Commission can relieve an SRO of specific regulatory functions by rule or order. Securities Exchange Act of 1934, § 17(d)(1)(A), 15 U.S.C. § 78q(d)(1)(A) (1976).

rulemaking affecting specialists. Exchanges, pursuant to Sections 6(b)(5) and 19(b), may propose rules regulating numerous matters, including the behavior of specialists.<sup>46</sup> The Commission responds to these proposals by approving or disapproving them pursuant to Section 19(b), thus employing its oversight authority.<sup>47</sup> Alternatively, the Commission could initiate its own regulation of specialists, regardless of whether an exchange has already chosen to act, by pursuing one of two courses of action. First, under Section 11(b), the Commission may adopt rules that would delineate the content of what must be contained in exchange rules regulating the behavior of specialists.<sup>48</sup> This use of indirect authority requires that the Commission initiate action. Second, Section 19(c) allows the SEC to act directly to amend the rules of an exchange to provide for regulation of specialists as the Commission finds acceptable. This use of direct authority also requires Commission initiation.

Similarly, in this area of discipline, the Commission has authority to deal with SRO rule violations by SRO member brokers: (i) directly by injunction under Section 21(d) of the 1934 Act;<sup>49</sup> (ii) indirectly by disciplining the SRO for failing to enforce its own rules pursuant to Section 19(h)(1);<sup>50</sup> or (iii) responsively by reviewing SRO disciplinary proceedings pursuant to Section 19(e).<sup>51</sup>

As a final example, in the area of policy setting the Commission could require that the national market system be structured so as to compel participating brokers to provide best execution for all customers who execute transactions within this system.<sup>52</sup> Consistent with the Commission's mandate to facilitate establishment of the National Mar-

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<sup>46</sup> 15 U.S.C. §§ 78f(b)(5), 78s(b) (1976).

<sup>47</sup> Sections 19(b)(1) and (2) of the 1934 Act require the Commission to publish SRO proposed rule filings, to allow interested persons an opportunity to submit comments, and to either approve the proposed rule or institute proceedings to determine its disapproval. 15 U.S.C. § 78s(b)(1), (2) (1976).

<sup>48</sup> Pursuant to § 11(b), the Commission has adopted Rule 11b-1. See Securities Exchange Act Rel. No. 7465 (Jan. 4, 1965). Rule 11b-1 dictates that exchange rules contain the following requirements: (i) that specialists maintain adequate minimum capital; (ii) that specialists engage in efforts to maintain fair and orderly markets and to limit other activities; (iii) that there be provisions stating the responsibilities of a specialist when acting as a broker; and (iv) that there be procedures established to provide for surveillance of specialists. 17 C.F.R. § 240.11b-1 (1982).

<sup>49</sup> 15 U.S.C. § 78u(d) (1976).

<sup>50</sup> *Id.* § 78s(h)(1) (1976).

<sup>51</sup> *Id.* § 78s(e) (1976).

<sup>52</sup> See generally Lipton, note 39 *supra*, at 449-63 (discussing significance of best execution to national market system).

ket System and to carry out its objectives, including assuring the practicability of best execution,<sup>53</sup> the Commission could require a best execution practice by brokers. It could use its direct authority, for example, by adopting a Commission rule under Section 10(b)<sup>54</sup> of the 1934 Act making it a manipulative practice for brokers to fail to seek best execution. The Commission could also act through indirect authority, pursuant to Section 11A(a)(3)(b), and require SROs to adopt appropriate rules to effect best execution of customer orders.<sup>55</sup> Finally, the Commission could respond to policy setting of the SROs by passing upon rules promulgated by the SROs to achieve a best execution practice.<sup>56</sup> In the last instance, the exchange would be initiating its policy through rulemaking activity.

These selected instances of overlapping authority between the Commission and the SROs are illustrated in the following chart:

SELECTED INSTANCES OF OVERLAPPING  
REGULATORY AUTHORITY

Regulatory Activity	SEC Initiating Authority (Direct)	SEC Initiating Authority (Indirect)	SEC Response Authority	SRO Initiating Authority
Discipline (generally, SRO members violating SRO rules)	§§ 21(a) & 21(e) (covers SRO rules & Sec. Acts violations) or § 19(h)(2) (covers only Sec. Acts violations)	§ 19(h)(1)(A) (disciplining exchanges for enforcement failures) & § 19(h)(4) (disciplining exchange officers for enforcement failures)	§§ 19(e)(1)(A), (B) & 19(e)(2) (reviewing exchange disciplinary sanctions)	§ 6(b)(6) (exchanges required to adopt rules establishing their own disciplinary mechanism) & § 19(g)(1) (exchanges compelled to directly enforce disciplinary rules)
Rulemaking and Order Granting (specifically regulating specialists)	§§ 19(c) (altering exchange rules) & 10(a) (adopting its own rules affecting exchange trading)	§ 11(b) & Rule 11b-1(a)(2)(ii) (determining nature of exchange rules dealing with specialists)	§ 19(b)(2) (approving exchange rule proposals)	§§ 19(b)(1), (2) (SEC approval needed) & 19(b)(3)(A) (no SEC approval needed if perfunctory)
Policy Setting (specifically, establishing national market system goal of best execution)	§§ 11A(a)(1)(C)(iv), 11A(a)(2) (authority to facilitate establishment of the national market system and goal of assuring best execution) & §10(b) (authority to define manipulative practices to include failure to seek best execution)	§ 11A(a)(3)(B) (authority to direct SROs to act in regulating a national market system)	§ 19(b)(2) (responding to rulemaking for policy ends by SROs)	§§ 19(b)(1), (2) (use of rulemaking for policy ends) (§ 11A(a)(2) does not exclude SRO initiatives)

<sup>53</sup> Securities Exchange Act of 1934, §§ 11A(a)(1)(C)(iv), 11A(a)(2), 15 U.S.C. §§ 78k-1(a)(1)(C)(iv), 78k-1(a)(2) (1976).

<sup>54</sup> *Id.* 10(b)5, 17 C.F.R. § 240.10b-5 (1982).

<sup>55</sup> 15 U.S.C. § 78k-1(a)(3)(b) (1976).

<sup>56</sup> In 1981, the Commission in fact approved exchange rule proposals establishing an anti-trade-through rule which was designed to encourage best execution in some instances. Securities Exchange Act Rel. No. 17703 (Apr. 9, 1981). See Lipton, note 39 *supra*, at 504-05 (analysis of anti-trade-through rule).

### III. DETERMINING WHO SHOULD EXERCISE WHICH AUTHORITY

#### A. *Maximizing Efficiency in the Resolution of Significant Market Regulatory Matters*

Allocating guidelines can be developed within the scheme of the Securities Exchange Act to determine whether the SEC should initiate regulatory activity or respond to the initiating efforts of an SRO. In instances when the Commission chooses to initiate a resolution, these guidelines can further suggest which authority it should employ.

To establish these guidelines for allocating regulatory authority three assumptions must be stated. The first, developed above,<sup>57</sup> is that regulation of securities trading markets is a cooperative effort performed by both the SEC and the SROs. The second assumption suggests that a basic presumption is built into the legislative scheme of self-regulation. The term self-regulation implies that the responsibility for the day-to-day administration of the trading markets rests with the self-regulatory bodies. This assumption is supported by examining the conditions prescribed for exchange registration. Exchanges will only be registered if the Commission determines that the applicant exchange has the machinery necessary to carry on the mundane administration of an exchange such as admitting members,<sup>58</sup> selecting directors fairly,<sup>59</sup> assessing dues and fees,<sup>60</sup> implementing fair trading,<sup>61</sup> enforcing its rules, disciplining violators,<sup>62</sup> and avoiding burdens on competition.<sup>63</sup> Clearly, these perfunctory chores are within the province of the SROs' regulatory authority. The assumption in favor of SRO responsibility for basic administration of the trading markets can also be deduced by examining the 1934 Act provisions governing rulemaking. These provisions permit SROs to adopt rule changes without Commission approval only for those matters dealing with other than significant market regulatory issues such as administration of the exchanges, explanations of present policies, and altering fee schedules.<sup>64</sup> If the proposed rule change deals with other than these perfunctory matters, the Commission's approval

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<sup>57</sup> See note 13 and accompanying text *supra*.

<sup>58</sup> Securities Exchange Act of 1934, §§ 6(b)(2), 6(c), 15 U.S.C. §§ 78f(b)(2), (c) (1976).

<sup>59</sup> *Id.* § 6(b)(3), 15 U.S.C. § 78f(b)(3) (1976).

<sup>60</sup> *Id.* § 6(b)(4), 15 U.S.C. § 78f(b)(4) (1976).

<sup>61</sup> *Id.* § 6(b)(5), 15 U.S.C. § 78f(b)(5) (1976).

<sup>62</sup> *Id.* §§ 6(b)(1), 6(b)(7), 6(d), 15 U.S.C. §§ 78f(b)(1), (b)(7), (d) (1976).

<sup>63</sup> *Id.* § 6(b)(8), 15 U.S.C. § 78f(b)(8) (1976).

<sup>64</sup> *Id.* § 19(b)(3)(A), 15 U.S.C. § 78s(b)(3)(A) (1976).



is required.<sup>65</sup>

Generally, for matters other than the daily administration of the trading markets, that is, those markets regulating issues with broad implications for the ability of trading markets to perform their capital formation and resource allocation functions, no comparable presumption exists in the statutory scheme that would establish jurisdiction for the SROs. The Commission, as readily as the SROs, could supervise the development of a component of the national market, modify the specialist system, or correct persistent SRO member disregard of Commission or exchange rules. For significant market regulatory matters, over which both the SEC and the SROs have potential authority, little guidance exists as to whether the SEC or the SROs should exercise initial regulatory authority.

The final assumption recognizes that the SROs represent an interest group — their respective memberships — and the SEC does not. The SROs are committed to executing the intent of the 1934 Act,<sup>66</sup> and yet, the exchanges are composed of members whose interests at times conflict with the goals of the 1934 Act.<sup>67</sup> On the other hand, the SEC, an independent, bipartisan, quasi-judicial government agency, is responsible for implementing the 1934 Act and represents no special interest group.<sup>68</sup>

The guidelines developed below accept the current legislative scheme

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<sup>65</sup> *Id.* §§ 19(b)(1), (b)(2), 15 U.S.C. §§ 78s(b)(1), (b)(2) (1976).

<sup>66</sup> To be registered, § 6(b)(1) requires that an exchange must be so organized and have the capacity to carry out the purposes of the 1934 Act. 15 U.S.C. § 78f(b)(1) (1976).

<sup>67</sup> The Senate Report accompanying the bill that was to become the 1934 Act recognized that "however zealously exchange authorities may supervise the business conduct of their members, the interests with which they are connected frequently conflict with the public interests." SENATE COMM. ON BANKING AND CURRENCY REPORT TO ACCOMPANY S. 3420, S. REP. NO. 792, 73rd Cong., 2d Sess. 4 (1934) [hereafter 1934 SENATE REPORT].

<sup>68</sup> Reliant upon Congress for operation and funding, the SEC is arguably more subject to political interests than the SROs. However, the SEC's bipartisan nature, its recognized independence, and its own code of ethics, militate against the SEC being responsive to political pressures. The bipartisan nature of the SEC is dictated by § 4(a) of the 1934 Act, 15 U.S.C. § 78d(a) (1976). The SEC's independence is well noted. See 3 L. LOSS, *SECURITIES REGULATION* 1878-83 (2d ed. 1961). The SEC's Canon of Ethics exhorts its members to maintain their independence and "reject any effort by representatives of the executive or legislative branches of the government to affect their independent determination of any matter being considered by this Commission. A member should not be swayed by partisan demands, public clamor or considerations of personal popularity or notoriety; so also he should be above fear of unjust criticism by anyone." 17 C.F.R. § 200.58 (1982).

and its enumerated assumptions and seek to maximize the utility of each party in resolving significant market regulatory matters. Given the intent of the legislation to allow either the SEC or the SROs to supervise many of the nonperfunctory market matters, the guidelines are designed to divide regulatory duties, in instances of dual authority, in a manner that ensures that the entity to whom responsibility is designated is the entity that has the greatest ability to regulate the matter.<sup>69</sup> Ability will be measured by two factors of efficiency: (i) the institutional resources that must be expended by the regulatory body<sup>70</sup> in order to obtain a satisfactory resolution of any particular regulatory issue,<sup>71</sup> and (ii) the likelihood that the institution can make its decision

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<sup>69</sup> Essentially, the goal of the guidelines is to provide a cost-benefit structure to allocate the regulatory responsibility between the SROs and the SEC. The allocation will be made on the basis of the resources each institution has to expend to resolve a specific regulatory matter. Implicit in this cost-benefit analysis is an assumption that the marginal cost of administering market regulatory operations does not differ substantially between the SEC and the SRO. This assumption is probably neither proveable nor disproveable and is beyond the scope of this article. However, there is no reason to believe that marginal operational costs differ between the SEC and the SROs. Disproof of this assumption would alter the conclusions reached below.

The criteria are intended to direct decision making responsibility in a manner that will resolve regulatory problems with the least expenditure of resources. In other words, the criteria will guide the achievement of the greatest regulatory results (value) per regulatory costs (resources). The economists would refer to these criteria as "efficiency criteria." See, e.g., R. POSNER, *ECONOMIC ANALYSIS OF LAW* 10-12 (2d ed. 1977).

<sup>70</sup> The guidelines also depend upon the assumption that the regulatory budgets of the SEC and the SROs can ultimately be altered, if necessary, to reflect any increase or decrease in regulatory responsibility created by a reallocation pursuant to the criteria.

If the criteria direct an efficient use of resources, concerns regarding the difference between the source of funds of the SROs and the SEC may still exist. The SROs are funded by the securities industry and ultimately, securities investors. The SEC is funded by the government (i.e., the taxpayers) and through fees which are primarily paid by parties who are assessed various registration, filing, and transaction fees. In 1980, 68% of the Commission's budget was funded by these fees. *SECURITIES AND EXCHANGE, 47TH ANNUAL REPORT* 163 (1980). The funds of the SROs are contributed by the Securities industry which, in turn, immediately benefits by the operations of the SROs. The government's portion of the SEC's funds is contributed by taxpayers who, in general, do not immediately benefit from the SEC's operations. Recognizing the closer identity between the immediate benefit of operations and source of funds which identity characterizes the SROs, some critics may wish to see the SROs rather than the SEC absorb a greater proportion of regulatory costs. This is, however, a social concern, and outside the scope of this article.

<sup>71</sup> The term satisfactory resolution assumes that there is a general concurrence among observers of securities market regulations as to what constitutes a satisfactory resolution of specific regulatory issues. At least, there should be general concurrence as

free from the influence of conflicting interests that might prevent the particular resolution of a specific problem from being in the best interests of the trading market.<sup>72</sup>

Regarding the first factor, there is no reason to assume that either the SEC or an SRO has inherently greater or lesser problem solving or administrative abilities.<sup>73</sup> Consequently, a priori predictions distinguishing the SEC and the SROs as regulators must be based upon a factor other than their inherent regulatory abilities. The guidelines developed below will be used to distinguish the SEC and the SROs as regulators based upon unique considerations arising from either (i) the particular expertise a regulatory body could bring to bear on a specific regulatory concern; (ii) the need, or absence thereof, for a uniform regulatory approach; or (iii) the presence or absence of duplicative efforts that a regulatory body must expend when responding to a specific regulatory concern.

Regarding the second factor of avoiding conflicts of interest,<sup>74</sup> and

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to what would not be a satisfactory resolution. If neither of these assumptions is true, the process of delegating regulatory authority becomes irrelevant to any cost-benefit analysis. All resolutions would be equally satisfactory. If so, all regulatory bodies should be directed to expend as few resources as possible in resolving issues and authority should be delegated on a random basis.

<sup>72</sup> If this second factor is not accepted as inherently reasonable, it could also be argued as a matter of efficiency. Regulatory ability could be measured by freedom from conflicts of interest between a regulator's self-interest and market regulatory goals regardless of whether the regulatory body would not capitulate to its self-interest in any given conflict. Assuming the regulatory body's self-interest differs from the interest of the trading markets and the regulatory body acts in its own interest, then its regulatory efforts would be inefficient. Ultimately these efforts, motivated by self-interest, would be inefficient because they would have to be corrected by the expenditure of additional regulatory resources. It would seem reasonable to assume that self-interest will not always be synonymous with overall trading market regulatory interest since the financial interest of one segment of the securities industry will not always be in the financial best interest of the entire industry. See note 67 *supra*.

On the other hand, if a regulatory body contradicted its self-interest and adopted a regulatory mode compatible with the overall well being of the trading markets, it is likely these efforts would also be inefficient. Considerable resources would have to be expended by the SRO staff in educating its constituency and overcoming a natural inclination of its constituency toward a maximization of self-interest. A self-regulatory body uninvolved in the conflict would not have to expend such resources.

<sup>73</sup> Some students of management techniques might argue that there are inherent administrative or problem resolving benefits or drawbacks in either government regulation or not-for-profit regulation. Obviously, if such conclusions could be proven, it would alter the outcome of this article.

<sup>74</sup> To posit as a goal the avoidance of conflicts of interest does not necessarily ignore benefits that can be brought to a regulatory process through the interaction of compet-

based upon our initial assumptions, there is reason to believe that the SEC will have a greater inherent regulatory utility than the SROs. The SROs represent a membership which is composed of profit motive entities. The SEC is an independent bipartisan government regulatory agency designed to be relatively insulated from the political process. In relevant part, its mandate is to implement the Securities Exchange Act of 1934 uninfluenced by outside pressures.<sup>75</sup>

With the goal of maximizing the utility of the regulatory bodies measured by the above two factors of efficiency, one could posit the following guidelines for allocating regulatory responsibility when dual authority exists:<sup>76</sup>

1. Decisions requiring technical expertise should be resolved by the regulatory institution with the greatest expertise. All else being equal, if a regulatory problem requires certain expertise possessed by only one institution, that institution would need to expend fewer resources in satisfactorily resolving the regulatory problem than the institution without that expertise.

2. Decisions involving conflicts of interest between the self-interests of a regulatory party and a specific regulatory goal should be resolved by the regulatory institution not involved in the conflict. As a practical matter, this particular criterion addresses the quality of a resolution to a specific issue as much as it addresses the efficiency of the process by which that resolution is achieved. Regulatory institutions resolving issues involving matters for which they have a self-interest that conflicts with regulatory goals are probably more apt to adopt a resolution not in the overall best interest of the trading markets than are institutions unaffected by the conflict. A resolution not in the best interests of the trading markets is inefficient because (i) it may not achieve all regulatory goals; and (ii) it may require the additional expenditure of corrective efforts.

3. Decisions requiring uniformity of approach for different SROs should be administered by the SEC. This is a variation of the second criterion. It avoids unnecessary expenditure of resources in reconciling conflicting interests. It also avoids the unnecessary expenditure of re-

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ing interests. In most instances, the SEC's decision making process allows input from competing interests during either a formal comment period or informal negotiations. Thus, the positions of the various parties to an issue can be argued before the Commission, but the Commission is unlikely to hold the position itself based merely on self-interest.

<sup>75</sup> See note 68 *supra*.

<sup>76</sup> The criteria enumerated in the text are not exhaustive of all of the factors relevant to allocating decision making responsibility.

sources in reconciling conflicting regulatory proposals that might not be so much reflective of self-interests, but rather reflective merely of different regulatory language, drafting techniques, or regulatory approaches. The application of the criterion does not eliminate expenditure of resources necessary to create a resolution that would accommodate multiple trading market frameworks. However, it allows a problem for which each constituency might be motivated by its own self-interest, to be resolved by an entity that need only consider the well being of the collective trading markets.

For example, assume there is a need for a uniform "suitability" rule allowing investors dealing with any broker in any market to know the responsibilities of a broker in recommending securities to the investor.<sup>77</sup> Each SRO might have its own resolution of the suitability rule question based upon certain self-interest. An SRO influenced by securities firms doing primarily a "retail" business might have a far more protective posture in framing a suitability rule than would an SRO influenced by firms doing other than primarily retail business. Assuming the need for a uniform rule, requiring various SROs to work together to forge one suitability rule would most likely be wasteful of resources because much time would be devoted to reconciling conflicting interests rather than examining the needs of the trading markets. Time would also be spent compromising language and regulatory approach. These resources would not need to be expended if an entity removed from the conflict, specifically the SEC, resolved the problem.

4. Decisions requiring diversity of approach for each SRO based upon differences in market structure should be administered by the individual SRO. This is a variation of the first criterion. Each SRO has a slightly different market structure. If the regulatory problem being confronted is to be resolved with solutions unique to each market, each SRO would be most familiar with the unique trading structure and needs of its own market, and thus, should resolve the issue individually. For the SEC to attempt resolution of the issue for each market would require the expenditure of resources necessary to understand the unique structure of each market in regard to the specific regulatory

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<sup>77</sup> Suitability rules are designed to assure that investment recommendations made by brokers are appropriate for the financial situation and investment objectives of the broker's clients. For example, the NASD's suitability rule requires brokers, in recommending securities to a customer, to have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL (CCH), NASD Rules of Fair Practice, art. III § 2, ¶ 2152 (1982).

problem. As an example, assume that regulatory need exists to develop or augment the affirmative duties of specialists.<sup>78</sup> Also assume that the regulatory resolution would not need to be uniform, but rather would be intended to consider the unique qualities of each trading market.<sup>79</sup> Rather than require the SEC to familiarize itself with the operation of each exchange in terms of this particular problem, resources would be used more efficiently if the individual exchanges devised their own specialist rules.

5. The Commission should resolve a problem when it has ultimate regulatory authority over a regulatory issue<sup>80</sup> and has already decided upon a specific resolution for which it needs no further technical assistance. This last criterion is a variation of the adage "if you already know the answer, don't ask the question." It wastes resources and duplicates efforts to allow SROs to attempt to resolve problems the resolutions of which are essentially predetermined.

### B. *Qualifications of the Allocating Guidelines*

Obviously, different allocating guidelines applied separately to the same problem will not always provide consistent resolutions. For example, if the Commission knows the goal it wants to reach regarding a specific regulatory problem, it would normally be wasteful of resources to have the SROs attempt a resolution. On the other hand, if the resolution in question is not to be uniform, but is intended to match the needs of the individual trading markets, then the solution should come from the SROs. These contradictory messages can both be satisfied if the SEC were to use its indirect authority to dictate a goal and then allow the SROs to use their familiarity with their respective trading markets in determining how best to effectuate that goal in their market.<sup>81</sup> In other instances, resolution of the conflicting messages might be

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<sup>78</sup> These duties basically require specialists to maintain fair and orderly markets. See, e.g., NYSE Rule 104.10, 2 NEW YORK STOCK EXCHANGE CONSTITUTION AND RULES (CCH) ¶ 2104.10 (1981). At present, only the NYSE and the AMEX are required to impose affirmative duties on their specialists. Securities Exchange Act Rel. No. 15575 (Nov. 23, 1964).

<sup>79</sup> For instance, some exchanges have a unitary specialist system, others have a competing specialist system. Affirmative duty rules for unitary specialists might well be different from similar rules for competing specialists.

<sup>80</sup> The Senate Report accompanying the 1975 Amendments emphasized that ultimate regulatory authority rested with the SEC. The SROs were seen as having "no authority to regulate independently of the SEC's control." 1975 SENATE REPORT, *supra* note 12, at 23.

<sup>81</sup> The indirect authority the Commission may use could be an informal employment

more difficult.

The allocating guidelines are designed for a field of joint authority embracing many matters for which no explicit guidelines exist. They are simple in structure, and not intended to be comprehensive in providing guidance for allocating regulatory responsibilities. Even with their simple design, however, application often requires a subjective interpretation of a regulatory problem. Different interpretations of the same problem might produce different recommendations regarding the identity of the regulatory body best equipped to resolve a problem. Questions of values are also raised in determining which self-interests are compatible with market regulatory goals and which self-interests conflict, or in determining when a uniform resolution is desirable and when it is not.

Creation of these allocating guidelines based upon maximizing the utility of regulatory bodies does not ignore subtle regulatory concerns that might be contrary to utility principles. The drafters of the 1934 Act were sensitive to avoid SEC domination of the exchanges,<sup>82</sup> recognizing that such a relationship might deprive the SROs of the initiative and responsibility to take care of their own problems.<sup>83</sup> Furthermore, the SROs often are responsible for enforcing regulations adopted by the Commission. Effective SRO enforcement might be encouraged by SRO participation in the regulation formulating process. The concern with placing too much responsibility in the hands of the SEC remains valid today. Therefore, the guidelines are based on the assumption that daily administration of the trading markets will remain with the SROs, thus leaving them with considerable unshared basic authority. Furthermore, regarding significant regulatory problems, responsibility for which would be allocated by means of the criteria, there is no reason to believe that the SEC would assume an expanded role in regulating the securities markets. The criteria would not necessarily increase or decrease the workload of the SEC. Responsibilities, however, might be

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of its direct authority. See text accompanying note 34 *supra*. The Commission would essentially say to the SROs, "Here's the result that is desired. Either you adopt the appropriate rules or we will."

<sup>82</sup> This concern was limited to domination only of the exchanges because the NASD was not in existence in 1934. The NASD became a registered national securities association in August, 1979.

<sup>83</sup> Letter from the President of the United States to the Chairman of the Committee on Banking and Currency with an Accompanying Report Relative to Stock Exchange Regulation, 73rd Cong., 2d Sess. 6 (Comm. print 1934). This report, by Secretary of Commerce Roper, was the basis of the 1934 legislation. It is commonly referred to as the "Roper Report."

allocated differently than they are currently.

When applying the guidelines, it should not be overlooked that even when regulatory problems exist, the time is not always ripe to devise regulatory solutions. Some problems need to percolate within the securities industry before resolutions are attempted. For these problems, it might be unrealistic to assess in advance with whom regulatory responsibility should ultimately rest. In those cases, the best course might be to place the issue in abeyance either by all parties refraining from assuming responsibility, or perhaps by an assumption or assignment of responsibility with an unusually lengthy deadline. Alternatively, responsibility might be assumed by or assigned to one regulatory body for a period of time to allow ideas to germinate. After some ideas are produced, it might be necessary to call on another regulatory body for implementation.<sup>84</sup>

The creation of guidelines to allocate responsibility when shared responsibility exists in formal regulatory activities does not ignore the fact that the Commission and the SRO do not always work through formal means of authority. Many regulatory problems are resolved through informal communications, joint discussions, study, bargaining and political activities.<sup>85</sup> Often these informal processes are appendages of the formal authority possessed by the SROs and the SEC.<sup>86</sup> In those instances, the guidelines might be applied to the informal regulatory practices as aptly as to the formal process. If the informal regulatory practices prove to be unrelated to the authority delegated to the SROs and the SEC under the 1934 Act, it might be appropriate to develop allocating criteria for the informal process. The proposed allocating guidelines are thought of only as a starting point for the development of a complete range of principles by which to allocate regulatory responsibilities.

#### IV. CASE STUDY APPLICATIONS

To appreciate how the guidelines might function, it is useful to see how an allocation of regulatory responsibilities might have been made for several regulatory matters that have recently confronted the securi-

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<sup>84</sup> See, e.g., note 200 *infra*.

<sup>85</sup> For two thoughtful discussions of the Commission's use of informal authority, see Jennings, note 10 *supra* and Comment, note 34 *supra*.

<sup>86</sup> Others have viewed the relationship between the authority granted by statute and the informal bargaining process as one in which "the statutory provisions are merely being used as an arsenal of weapons through which the SEC has bargaining leverage at the informal level." Comment, note 34 *supra*, at 819.



ties industry. These are matters for which regulatory authority was possessed both by the SEC and the SROs.

### A. *Options Study Recommendations*

The Commission's plan to implement the recommendations of the Report on Special Study of the Options Markets (Options Study Report)<sup>87</sup> presents a good opportunity to deduce divisions of responsibility by applying the allocating guidelines to a case in which regulatory authority is shared by the SEC and the SROs. In response to abusive practices in the trading of standardized options and the Commission's sense that the registered options exchanges were unable to insure their maintenance of fair and orderly markets, the Commission effectively created a moratorium on further expansion in options programs,<sup>88</sup> and initiated a study of the options markets. The study resulted in the Options Study Report, released in 1979.<sup>89</sup> Shortly after its release, the Commission developed its plan to implement the recommendations for regulatory reform proposed in the report.<sup>90</sup> Only upon successful implementation of certain of the recommendations was the Commission willing to lift its options program moratorium.<sup>91</sup>

Both the Commission and the various option exchanges possessed the authority to implement many of the recommendations.<sup>92</sup> The SROs, pursuant to Sections 6(b) and 19(b) rulemaking authority, were in a position to propose resolutions of various problems raised by the Study

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<sup>87</sup> SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKET FOR HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96th Cong., 1st Sess. (Comm. Print 1978) [hereafter *OPTIONS STUDY REPORT*]. The Commission's implementation plan was published in Securities Exchange Act Rel. No. 15575 (Feb. 22, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,962 (Feb. 22, 1979), 16 SEC DOCKET 1163 (Mar. 6, 1979) [hereafter *Implementation Plan*].

<sup>88</sup> Securities Exchange Act Rel. No. 14056 (Oct. 17, 1977).

<sup>89</sup> Securities Exchange Act Rel. No. 15569 (Feb. 15, 1979).

<sup>90</sup> Implementation Plan, note 87 *supra*.

<sup>91</sup> Implementation Plan, note 87 *supra*, at 81,413.

<sup>92</sup> One could argue that the question of who has the authority to initiate implementation of the Options Study Report is irrelevant. Because the Options Study Report was a Commission Study, it could be said that the Commission initiated the resolution of all of the problems raised by the Study. However, as a practical matter, some of the problems were resolved by the SROs and others by the SEC. In almost all instances, there was no legislative mandate for a problem to be handled by the SROs or the SEC. For each instance in which implementation was allocated to the SEC or an SRO, a rationale should exist for the allocation. It is this allocation to which the guidelines are to be applied.

for which approval or disapproval authority would rest with the Commission. On the other hand, the Commission possessed direct rulemaking authority to resolve numerous matters discussed in the Options Study Report. Resolution may have been effected through the Commission's authority to specifically regulate options trading,<sup>93</sup> directly implement exchange rules,<sup>94</sup> or generally regulate specific trading oversight matters.<sup>95</sup>

The Commission's Implementation Plan specified those actions it would ask the SROs to take and those the SEC would take in response to the Options Study Report's recommendations.<sup>96</sup> Many of the recommendations involved routine operating problems of the exchanges.<sup>97</sup> For these perfunctory matters, responsibility was typically delegated to the SROs in accordance with basic principles of self-regulation.<sup>98</sup> Other problems involved significant policy decisions.<sup>99</sup> For these matters, responsibility was occasionally delegated to the SROs and sometimes assumed by the SEC.

The Commission's basis for its delegation of authority was not identified in the Options Study Report. It may be instructive, however, to examine one of the problems addressed, and determine what result the guidelines would have dictated in allocating regulatory initiative.

The Options Study Report contained a series of recommendations concerning the content and use of suitability forms. The possession of accurate information about a customer's financial resources and investment objectives is critical to a broker's compliance with his fiduciary obligation of making only those recommendations suitable to a customer's financial situation and needs.<sup>100</sup> The Options Study Report disclosed that it was "not uncommon to find inaccurate suitability infor-

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<sup>93</sup> Securities Exchange Act of 1934, § 9(b), 15 U.S.C. § 78i(b) (1976).

<sup>94</sup> *Id.* § 19(c), 15 U.S.C. § 78s(b) (1976).

<sup>95</sup> For example, the Commission has authority to regulate record making and keeping by the SROs and brokers. *Id.* § 17, 15 U.S.C. § 78q(b) (1976).

<sup>96</sup> Implementation Plan, note 87 *supra*. The Commission also sub-categorized the problems to be resolved by time periods in which a resolution was to be achieved. For example, some problems were to be resolved before the options moratorium would be lifted and some thereafter. *Id.*

<sup>97</sup> For example, the exchanges were directed to retain written records of oral customer complaints and revise account selection procedures when conducting routine examinations to insure valid random selection of accounts. [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,962 at 81,418, Proposals I(B)(1)(g) and I(B)(1)(b).

<sup>98</sup> See text accompanying notes 58-65 *supra*.

<sup>99</sup> See, e.g., notes 100-106 and accompanying text *infra*.

<sup>100</sup> For a general discussion of a broker's suitability duties, see N. WOLFSON, note 11 *supra*, at ¶ 2.08.

mation about a customer contained in the files of broker dealer firms."<sup>101</sup> The Report recommended that (i) suitability reports be standardized and brokerage firms adopt procedures to insure that all suitability information be properly recorded;<sup>102</sup> (ii) information collected on options forms be verified by the options customer;<sup>103</sup> and (iii) brokerage firms semi-annually confirm the currency of suitability information with the customer.<sup>104</sup>

The Options Study Report identified unsuitable options trading as a "major regulatory concern."<sup>105</sup> As such, it may be categorized as a significant regulatory matter for which no presumption would necessarily exist as to whether the Commission or an SRO should respond. Historically, both the SROs and the SEC have regulated brokerage firm information gathering and retention processes similar in nature to the matters covered by these proposals.<sup>106</sup>

Implementation of each recommendation would require significant financial cost to brokerage firms in return for, at best, limited short term benefits to these firms.<sup>107</sup> Thus, the self-interest of the brokerage firms — the constituency of the various option exchanges — would be in conflict with the market regulatory goals established by the Options Study Report. This conflict of interest would suggest that the suitability information recommendations would be best implemented by the SEC.

On the other hand, the expertise as to how to construct a suitability form and to determine how to keep information current would rest with the options industry. This possession of expertise suggests that each SRO implement the recommendations.<sup>108</sup>

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<sup>101</sup> OPTIONS STUDY REPORT, note 87 *supra*, at 348.

<sup>102</sup> *Id.* at 354.

<sup>103</sup> *Id.* at 350.

<sup>104</sup> *Id.* at 357.

<sup>105</sup> *Id.* at 337.

<sup>106</sup> For example, the Commission's Rule 17a-3, 17 C.F.R. § 240.17a-3 (1982), requires exchange member brokers to make and keep current records of business transactions with nonmember brokers, and NYSE Rule 410 requires member firms to keep records of orders sent or carried to the exchange floor for execution, NEW YORK STOCK EXCHANGE, INC. CONSTITUTION AND RULES (CCH) ¶ 2410 (1981).

<sup>107</sup> In the short term, conscientious attempts to keep current information might provide some investors with increased confidence in a specific brokerage firm. On the other hand, it might be perceived by other investors as an invasion of privacy. In the long term, improved suitability information might minimize successful customer litigation against brokerage firms for unsuitable securities recommendations.

<sup>108</sup> To illustrate that the SROs did possess specific expertise, the responding proposals which were developed by the SROs and ultimately approved by the SEC, in many ways altered the recommendations found in the Options Study Report. For example,

The use of indirect authority by the Commission could satisfy both suggestions. Because the recommendations reiterated in the Implementation Plan were structurally detailed, the Commission would be able to provide the exchanges with a specific indication of how the suitability information form problem should be resolved. Constrained by the specific dictates of the Commission recommendations, the SROs would be limited in their capacity to accommodate their own self-interests when these self-interests conflicted with the outcome required by the recommendations. In addition, by directing that the exchange adopt rules to work out details of the recommendations, the Commission would be able to benefit from the experience possessed by the SROs. Thus, the allocating guidelines direct that an efficient use of resources would be for the Commission to utilize its indirect authority and require the SROs to develop appropriate rules to implement the specific suitability information form recommendation. In the Implementation Plan, this was the Commission's approach.<sup>109</sup>

It is interesting to note that, to encourage prompt action by the SROs, the Commission indicated that it would not lift its moratorium on options trading program expansion until the SROs completed their assignment.<sup>110</sup> This limitation on expansion created an incentive for prompt action by SROs. Thus, the SROs' interest was consistent with the specific market regulatory goals defined by the Options Study Report. This positive self-interest works against conflicting self-interest that would otherwise influence the SROs (such as the conflicting self-interest of seeking to avoid the additional expense of implementing the Report's recommendations).

Significantly, when matters were delegated to the SROs, the Commission requested uniform rule submissions from all of the SROs.<sup>111</sup> This request for a voluntary cooperative response was not made for reasons of efficiency. Rather, the Commission indicated that its resources were "not sufficient to permit it to respond to separate and va-

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the SROs substituted their own schemes for keeping the account information current and did not rely on a semi-annual mailing to customers. *See, e.g.*, rule proposals of the MSE, art. 43, Rule 3, Securities Exchange Act Rel. No. 16254 (Oct. 5, 1979), 44 Fed. Reg. 59,974 (Oct. 17, 1979), 18 SEC DOCKET 612 (Oct. 23, 1979). The Commission apparently appreciated the need to alter the recommendation and approved the proposals, Securities Exchange Act Rel. No. 16695 (Mar. 25, 1980), 19 SEC DOCKET 994 (Apr. 8, 1980); Securities Exchange Act Rel. No. 16696 (Mar. 26, 1980).

<sup>109</sup> Implementation Plan, note 87 *supra*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,962 at 81,415.

<sup>110</sup> *Id.* at 81,413.

<sup>111</sup> *Id.*

rying self-regulatory proposals to implement the Options Study Recommendations" in a limited period of time.<sup>112</sup> In fact, uniform submissions might not have provided the most efficient regulatory approach. Uniformity potentially compelled exchanges to resolve differences arising from self-interests. Such differences would not need to be resolved had a uniform regulatory resolution been unnecessary.<sup>113</sup> It is quite possible that, to some degree, the realities of limited SEC resources might have compelled an inefficient resolution of a regulatory concern.

### B. Best Execution Rule

The SEC and the SROs also share regulatory authority over the policy setting/rulemaking question of whether to require brokers using the national market system facilities to seek to execute public orders at the best possible price. The concern that brokers obtain best execution is related to the particular trading characteristics of our domestic securities markets and from the congressionally mandated goal of developing a national market system.<sup>114</sup> With the existence of dual listings and the granting of unlisted trading privileges, the same security is often traded in different markets at variant prices.<sup>115</sup> Brokers have a duty to execute customer orders at the best possible prices,<sup>116</sup> which duty has arguably been heightened through the availability of certain national market system improvements.<sup>117</sup> As a general rule, however, customer orders are often routed automatically to a pre-selected market which may or may not be quoting the best price at any given point in time.<sup>118</sup> This practice

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<sup>112</sup> *Id.* In this instance, the Commission did not indicate that limited resources compelled it to delegate responsibility to exchanges, but rather that when the responsibilities were delegated, the responses needed to be uniform. In other situations, limited Commission resources might compel delegation of responsibility even if efficient decision making would not direct such delegation.

<sup>113</sup> As an example, there seems to be no inherent need for uniformity in rules requiring member firms to keep copies of customer complaints at branch offices and headquarters offices. *Id.* at 81,415, Recommendations I(A)(1)(f).

<sup>114</sup> See note 53 *supra*.

<sup>115</sup> For a general discussion of how dual trading arose on domestic securities markets, see Werner, *Adventure in Social Control of Finance: The National Market System for Securities*, 75 COLUM. L. REV. 1233, 1241-44, 1246-53 (1975).

<sup>116</sup> See Lipton, note 39 *supra*, at 463-82.

<sup>117</sup> *Id.* at 471, 474.

<sup>118</sup> The 1975 Senate Report states that "[l]arge brokerage firms rely heavily on high speed systems for the direction of orders to a designated facility for execution. The [Senate] Committee has been informed that many of these systems are currently geared to route orders for any particular security to only one market center, e.g., the NYSE." 1975 SENATE REPORT, note 12 *supra*, at 104. In 1981, the Commission confirmed that

of not seeking best price executions works against the national market system goal of competition expressed by Congress in 1975.<sup>119</sup> Competition between market centers can only be sustained if brokers "reward" competitive market makers by directing order flow to the market with the best price.<sup>120</sup>

In addition, observing best execution duties is important to the efficient operation of certain national market facilities and rules. A central element of the national market system is the quote rule<sup>121</sup> and the composite quotation system.<sup>122</sup> The quote rule requires market centers to collect quotation information generated during their operations regarding national market system securities. The market center must then make the information available to securities information vendors for dissemination to the securities industry and the public. The quotation information generated is disseminated through the composite quotation system, enabling brokers to route orders to markets providing the best executions, thereby increasing the order flow to those markets. Failure of brokers to seek best execution removes the incentive for exchange members to provide, and for exchanges to collect and forward, reliable quotation information. This lack of incentive prevents the Composite

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this routing practice still continued, noting that retail firms "route their retail order in [Rule 19c-3] securities to the primary markets." SECURITIES AND EXCHANGE COMMISSION, A MONITORING REPORT ON OPERATION AND EFFECTS OF RULE 19C-3 UNDER THE SECURITIES EXCHANGE ACT OF 1934 at 17 (1981), Securities Exchange Act Rel. No. 18062 (Aug. 25, 1981), [1981 Transfer Binder]-FED. SEC. L. REP. (CCH) ¶ 83,024 (Aug. 25, 1981), 23 SEC DOCKET 650, 660 (Sept. 8, 1981) [hereafter RULE 19C-3 MONITORING REPORT].

<sup>119</sup> In the 1975 Amendments to the Securities Exchange Act, Congress found that "[i]t is in the public interest and appropriate for the protection of investors and maintenance of fair and orderly markets to assure . . . fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets." Securities Exchange Act of 1934, § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (1976).

<sup>120</sup> In explaining its plans for a national market system in 1973, the Commission stated that it is "[t]he desire to attract business [which] provides incentive to a market maker to bid higher or offer lower than his competitors." SECURITIES AND EXCHANGE COMMISSION, STRUCTURE OF A CENTRAL MARKET SYSTEM, *reprinted in* 3 HEARINGS ON H.R. 5050 & 340, BEFORE THE SUBCOMM. ON COMMERCE & FINANCE OF THE HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, H.R. REP. NO. 52, 93rd Cong., 1st Sess. 912 (1974) [hereafter 1973 POLICY STATEMENT].

<sup>121</sup> Rule 11A(c)(1)-(1), 17 C.F.R. § 240.11Ac1-1 (1982).

<sup>122</sup> The composite quotation system (CQS) is one of the communication systems designed to integrate the competitive market centers of the national market system. The Commission has described CQS as being "[a]t the heart of the central market system." 1973 POLICY STATEMENT, note 120 *supra*, at 64.

Quotation System (CQS) from operating as effectively as possible.<sup>123</sup> Thus, the failure of brokers to consistently seek best price execution is a significant regulatory concern because it not only denies investors the benefit of the best price in specific transactions, but it also inhibits achievement of the national market system goal of competitive markets, and prevents the efficient functioning of essential national market system mechanisms such as CQS.

Both the SROs and the SEC have the authority to require brokers to seek best price execution in their transactions. Specifically, Section 6(b)(5) of the 1934 Act requires exchanges to have rules which are designed "to remove impediments to and perfect the mechanisms of . . . a national market system."<sup>124</sup> Pursuant to Section 19(b), exchanges may adopt rules requiring brokers to seek best execution to facilitate the goals of the national market system. Similarly, the Commission is directed by Section 11A(a)(1) of the 1934 Act "to facilitate the establishment of a national market system."<sup>125</sup> The Commission could take direct action and adopt best execution rules for the exchanges pursuant to Section 19(c).<sup>126</sup> It could also promulgate its own best execution rules pursuant to the anti-manipulative provisions of Section 10(b).<sup>127</sup> Alternatively, the Commission could take disciplinary action under Section 15(b) of the 1934 Act against brokers who fail to seek best execution, and thereby violate their existing fiduciary duties.<sup>128</sup> Finally, the Com-

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<sup>123</sup> In order to comply with the quote rule, regional specialists have developed computer systems (commonly referred to as "autoquote" systems) which automatically generate questions based upon current quotations on the primary exchanges. These autoquote machines are frequently programmed to disseminate quotations at a fraction of a point inferior to ("away from") the primary market. Although such quotations technically comply with the quote rule, 1) they do not encourage meaningful competition, 2) they serve to clutter the CQS information stream, and 3) they add to a perception of unreliability of regional quotations because these quotations are not always honored. In response to these problems the Commission in 1981 proposed modifying the quote rule to limit its mandatory application largely to the primary exchanges and those brokers trading thereon. See Securities Exchange Act Rel. No. 17583 (Feb. 27, 1981), 46 Fed. Reg. 15,713 (1981) [hereafter Quote Rule Modification Proposal Release]. The Commission adopted these proposals in 1982. Securities Exchange Act Rel. No. 18482 (Feb. 11, 1982), [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,098 [hereafter Quote Rule Modification Adoption Release].

<sup>124</sup> Securities Exchange Act of 1934, § 6(b)(5), 15 U.S.C. § 78f(b)(5) (1976).

<sup>125</sup> 15 U.S.C. § 78k-1(a)(2) (1976).

<sup>126</sup> *Id.* § 78s(c) (1976).

<sup>127</sup> A broker's failure to seek best execution could be an intentional misstatement of a broker's implied representation to seek out the best market for his customer's transactions. See Lipton, note 39 *supra*, at 475.

<sup>128</sup> 15 U.S.C. § 79o(b) (1976).

mission could take indirect action by suggesting to exchanges that they adopt a best execution rule, with the implicit threat that if the exchanges do not so act, the Commission will.

Using the allocating guidelines, the following observations can be made: First, regulation of the best execution question would place the primary SROs in a conflict situation with their constituencies. Traditionally, the New York Stock Exchange<sup>129</sup> and the American Stock Exchange<sup>130</sup> have opposed a best execution rule. Although their opposition has been cast in terms of cost and efficiency arguments,<sup>131</sup> these two exchanges are the major beneficiaries of the brokerage order routing system that generally sends orders automatically to the primary markets.<sup>132</sup> Also, the membership of these exchanges is comprised of several major brokerage houses that have opposed a best execution rule.<sup>133</sup> The opposition of these brokerage houses has been expressed in terms of a cost-benefit analysis.<sup>134</sup> Again, it is difficult not to speculate as to whether this brokerage industry opposition is based in part upon a concern with absorbing the cost of complying with a best execution rule.

For these exchanges to become involved with the best execution question in a neutral manner might require them to first counter the interests of their own constituencies. To the extent that the exchanges are unwilling or unable to ignore their self-interests, they augment the possibility that their regulatory decisions will not serve the interests of all of the securities markets.

Second, the Commission essentially knows the result it would like

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<sup>129</sup> Letter from J.E. Buck, NYSE Secretary, to George A. Fitzsimmons, SEC Secretary (Aug. 24, 1978), SEC File No. S7-735a (copy on file at U.C. Davis Law Review office).

<sup>130</sup> Letter from Robert J. Birnbaum, ASE President, to George A. Fitzsimmons, SEC Secretary (Aug. 22, 1978), SEC File No. S7-735a (copy on file at U.C. Davis Law Review office).

<sup>131</sup> *Id.*

<sup>132</sup> On the other hand, the regional exchanges, which believe they would gain volume were a mandatory execution rule in effect, have typically supported a best execution rule. Letter from James E. Dowd, BSE President, to George A. Fitzsimmons, SEC Secretary (Oct. 22, 1976), SEC File No. S7-648; Letter from G. Robert Ackerman, PSE President, to George A. Fitzsimmons, SEC Secretary (Aug. 10, 1977), SEC File No. S7-684; PHILADELPHIA STOCK EXCHANGE, REPORT ON THE NATIONAL MARKET SYSTEM 20 (July 28, 1976) (copy on file at U.C. Davis Law Review office).

<sup>133</sup> Letter from Bache Halsey Stuart Shields, Inc.; Blyth Eastman Dillon & Co., Inc.; Dean Witter Reynolds Inc.; E.F. Hutton & Co. Inc.; Merrill Lynch & Co. Inc.; Paine, Webber, Jackson & Curtis, Inc.; Smith Barney, Harris, Upham & Co. Inc.; and Thomson McKinnon Securities Inc. to George A. Fitzsimmons, SEC Secretary (Aug. 1, 1978), SEC File No. S7-735a (copy on file at U.C. Davis Law Review office).

<sup>134</sup> *Id.*



regarding the question of best execution. With the adoption of the quote rule in 1978, the Commission indicated it thereafter expected brokers "to give careful consideration to [quotation] information in making their order routing decisions."<sup>135</sup> At the same time, in a release that provided direction for the development of the national market system, the Commission went so far as to suggest the adoption of rules (i) requiring brokers to demonstrate that they considered all market quotations before routing public orders; (ii) prohibiting brokers from using order routing systems biased in favor of a particular market; and (iii) prohibiting SROs from offering to brokers such non-neutral order routing facilities.<sup>136</sup> Thus, not only did the Commission have the authority to regulate brokers regarding best execution, but, it indicated how it would like to so regulate the brokers, perhaps leaving only technical details to be resolved by the SROs.

The best execution issue could not be assumed to fall under the category of non-significant regulatory issues that SROs might regulate as a perfunctory responsibility. As discussed above, brokers' achievement of best execution is central to the development of a national market system. The question is whether this issue with broad market implications should be regulated by the SEC or the SROs. In light of the conflicts of interests in which some exchanges would be enveloped in developing a best execution rule, and the extent to which the SEC had already conceptualized a regulatory resolution of the best execution issue, the allocating guidelines would suggest that the SEC should assume responsibility for initiating regulation of the best execution issue through its direct authority. If it were shown that particular market expertise would be required to resolve how a best execution rule might function in any given market, it might be advised that the SEC employ indirect authority, perhaps by hinting at Commission direct action, and require the SROs to develop resolutions that would conform to overall Commission directives.

The Commission has acknowledged its concerns with the best execution problem. On occasion, the Commission has indicated that automatic routing of orders to markets on a basis other than best price is

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<sup>135</sup> Securities Exchange Act Rel. No. 14415 (Jan. 26, 1978), 43 Fed. Reg. 4,342, 4,347 (Feb. 1, 1978), 14 SEC DOCKET 14 (Feb. 7, 1978) [hereafter *Quote Rule Release*].

<sup>136</sup> Securities Exchange Act Rel. No. 14416 (Jan. 25, 1978), 43 Fed. Reg. 4,354, 4,359 (Feb. 9, 1978), 14 SEC DOCKET 31 (Feb. 7, 1978) [hereafter *Development Release*].

incompatible with national market system goals.<sup>137</sup> The Commission has also implied that it has the rulemaking authority necessary to ensure that brokers achieve best price routing.<sup>138</sup> As a historical matter, however, the Commission has consistently and specifically declined the opportunity to take regulatory initiative in establishing a best execution rule. In 1978, prior to the complete development of the Composite Quotation System and of the intermarket trading system (ITS),<sup>139</sup> two mechanisms essential to brokers obtaining best executions, the Commission stated that it did not then believe it "reasonable . . . to require brokers under all circumstances to route their customers' orders to the market displaying the best quotation."<sup>140</sup> Even in 1979, after CQS and ITS had been shown to be viable and useful components in the national market system, the Commission continued to refrain from considering whether "order by order routing of retail orders to the best market in size should be required in a national market system."<sup>141</sup> The Commission based its inaction on concerns with the lack of development in communication and execution systems linking the markets. The Commission thus hinted that the best execution issue was not ripe for regulation, although other Commission releases emphasized the importance of obtaining best execution. Since 1979, the Commission has repeated its earlier explanation for deferring adoption of a best execution rule in response to suggestions for promulgation of such a rule.<sup>142</sup>

The Commission's reluctance to initiate regulatory activity concerning best execution left the proverbial ball in the SROs' court. The exchanges assumed this responsibility and in 1981 initiated regulatory action designed in part to help ensure brokers' seeking best price execution. The participating exchanges of the intermarket trading system proposed an "anti-trade-through" rule designed to discourage any

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<sup>137</sup> *E.g., id.*

<sup>138</sup> *Id.*

<sup>139</sup> The intermarket trading system, operating between the seven major national securities markets and the NASD, is a linkage system which permits executions to be made in any linked market center by brokers physically present in another market center. Thus, a broker can quickly execute orders in the best market even if the execution occurs in a market in which he is not physically present. *See generally* SECURITIES AND EXCHANGE COMMISSION, A REPORT ON THE OPERATION OF THE INTERMARKET TRADING SYSTEM: 1978-81 (1982) [hereafter ITS REPORT].

<sup>140</sup> Quote Rule Release, note 135 *supra*, at 4,347.

<sup>141</sup> Securities Exchange Act Rel. No. 15671 (Mar. 22, 1979), 44 Fed. Reg. 20,360, 20,366 (Apr. 4, 1979).

<sup>142</sup> Quote Rule Modification Adoption Release, note 123 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,098 at 84,096. *See also* Securities Exchange Act Rel. No. 16590 (Feb. 19, 1980), 19 SEC DOCKET 639, 675 (Mar. 4, 1980).

exchange member from executing transactions in ITS listed securities at a price inferior to the price at which the security was being publicly offered on any other participating ITS market center.<sup>143</sup> The rule proposal provided that the initiating broker, who "traded through" at an inferior price, assure that the public orders which did not receive the benefit of the better available quotation (because the initiating broker "traded through" such orders) be compensated by the initiating broker as if no trade-through occurred. However, this proposed remedy applied only if (i) the transaction was for more than 100 shares; (ii) a complaint was made by the market center displaying the order that was traded through; and (iii) such complaint was made within five minutes of the reporting of the transaction.<sup>144</sup>

The exchanges proposed the anti-trade-through rule in part to "contribute to the best execution for public orders." The Commission approved the proposal in April 1981,<sup>145</sup> demonstrating that it was not opposed to the general concept of a best execution rule for brokers, but only that it was unwilling to assume the initiative in encouraging such a rule.

The exchange anti-trade-through rule is a flawed substitute for a best execution rule. As the Commission itself commented, the exchange rule relies upon a complaint being made by the broker whose order was traded through.<sup>146</sup> The economic interests of such a broker might not warrant complaint even though his customer might not have received a best execution.<sup>147</sup> Second, in a busy trading environment, brokers cannot always take the time to raise complaints within the five minutes allotted. Third, the rule does not really provide a mechanism for the public customer to complain of a best execution failure because such failure would rarely if ever be known to the customer within five minutes of its reporting. In addition, a customer does not have a personal

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<sup>143</sup> The proposal was made pursuant to §§ 19(b)(1) and 19(b)(4) of the 1934 Act, 15 U.S.C. § 78s (1976). Securities Exchange Act Rel. No. 17579 (Feb. 26, 1981), 46 Fed. Reg. 14,876 (Apr. 3, 1981), 22 SEC DOCKET 195 (Mar. 10, 1981); Securities Exchange Act Rel. No. 17671 (Mar. 30, 1981), 46 Fed. Reg. 20,345 (Apr. 3, 1981), 46 Fed. Reg. 16,770 (Mar. 13, 1981), 22 SEC DOCKET 658 (Apr. 14, 1981).

<sup>144</sup> See note 143 *supra*.

<sup>145</sup> Securities Exchange Act Rel. No. 17704 (Apr. 9, 1981), 22 SEC DOCKET 709 (Apr. 21, 1981).

<sup>146</sup> The NASD, in urging the Commission to adopt a best execution rule, has argued that the exchange anti-trade rules do not satisfy the need for such a rule because of their "many exceptions." Letter from Gordon S. Macklin, President of the NASD, to George A. Fitzsimmons, Secretary of the SEC (July 23, 1982) (copy on file at U.C. Davis Law Review office).

<sup>147</sup> 22 SEC DOCKET at 710 n.3.

protest under the anti-trade-through rules. Finally, because the rule does not apply to executions of less than 101 share orders, small public order customers, which comprise nearly one-third of all transactions on the NYSE, are denied the rule's protection.<sup>148</sup>

The anti-trade through rules have not achieved neutral order routing by large retail brokerage houses. A year after the exchanges adopted their rules, the Commission observed that "retail brokerage firms commonly route, on an automated basis, most of their customer orders directly to the primary exchanges irrespective of the displayed quotations of the other market centers."<sup>149</sup> The rule also does not appear to significantly reduce the amount of trade-throughs occurring on ITS.<sup>150</sup>

Failure of the exchange initiated "best execution" rules to achieve neutral order flow has contributed to certain inefficiencies in overall market regulations. The Commission has recently concluded that its goal of increasing intermarket competition for order flow by requiring dissemination of firm quotations by market makers has not been achieved.<sup>151</sup> This goal is a central element of the Commission's national market system regulatory mandate.<sup>152</sup> Blame for not attaining this goal was placed in part upon the non-neutral routing of orders,<sup>153</sup> which routing frequently contravenes a broker's duty of best execution.

The failure of the anti-trade-through rule to achieve neutral order flow has also compelled the Commission to significantly dilute the effectiveness of a national market mechanism — CQS — a mechanism

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<sup>148</sup> In 1980, 100 share orders accounted for 31% of all transactions on the NYSE. NYSE FACT BOOK 8 (1981). This figure would probably be higher for the regional exchanges, but comparable statistics are not readily available.

<sup>149</sup> Quote Rule Modification Adoption Release, note 123 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,098 at 84,851. See also RULE 19C-3 MONITORING REPORT, note 118 *supra*, at 12.

<sup>150</sup> ITS REPORT, note 139 *supra*, at 36-38. Trade-through statistics in this report reflect the number of trade-throughs occurring as a percent of trades in ITS stocks in four separate weeks during a year, each spaced three months apart. The average of the selected weeks prior to the adoption of the anti-trade-through rule was .62%. After the rule, the average, for the weeks involved, was .47%. However, these weekly statistics appear to go up and down regularly with no certain pattern. For example, two of the selected weeks prior to the trade-through rule had trade-throughs of only .47% and .30% respectively.

<sup>151</sup> "[W]here regional exchanges have elected to compete on the basis of display quotations, that competition has not, for the most part, had any significant effect on order flow patterns." Quote Rule Modification Adoption Release, note 123 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,098 at 84,851.

<sup>152</sup> See text accompanying note 119 *supra*.

<sup>153</sup> Quote Rule Modification Adoption Release, note 123 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,098 at 84,851.

often considered central to the effective operation of this congressionally approved national market.<sup>154</sup> In February 1982, recognizing that order flow was not responding to competitively disseminated quotations, the Commission revised the quote rule and eliminated the need for many of the market makers previously covered to continue participation in the consolidated quotation system. The Commission essentially abandoned its earlier held hope of including these now exempt market makers in a competitive national market system.

It can be concluded that the exchange anti-trade-through rules did not achieve neutral order flow as a best execution rule might have achieved and also that absence of neutral order flow has led to certain regulatory inefficiencies. This, however, does not necessarily demonstrate that the regulatory authority allocating approach used for the best execution issue was inherently flawed. At the same time it cannot be ignored that the shortcomings of the resolution adopted by the exchanges is closely linked to the conflicts experienced by the primary exchanges between interests of their constituencies and national market system goals. Exchange member self-interest appears to have been opposed to a neutral order flow system and the anti-trade-through rules did not compel neutral order flow. If indeed this conflict of interest led to the unsatisfactory result, then allocating regulatory authority to exchanges, in this instance, proved inefficient.

### C. Anti-Internalization Rules

A final regulatory problem useful to examine is the implementation of anti-internalization rules<sup>155</sup> to govern trading on the intermarket trading system. This is also a matter for which initiating regulatory authority could be exercised by the SEC or by the SROs.

The Commission adopted Rule 19c-3 in June 1980,<sup>156</sup> removing off-

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<sup>154</sup> In 1979, then Chairman Williams stated that CQS was a "fundamental building block of the national market system" and that "quotation information from all markets was prerequisite to providing investors with the ability to assure that their orders received the best possible execution." *Joint Hearings on Progress Toward the Development of a National Market System Before the Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce*, 96th Cong., 1st Sess. 450 (1979) (opening statement of Chairman Rep. Harold M. Williams).

<sup>155</sup> When this article went to press, no anti-internalization rule had yet been adopted.

<sup>156</sup> Securities Exchange Act Rel. No. 16888 (June 11, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,608 [hereafter Rule 19c-3 Adoption Release]; 17 C.F.R. § 140.19c-3 (1982).

board trading restrictions<sup>157</sup> for a limited number of exchange traded securities.<sup>158</sup> Although the Commission believed that the rule's adoption would provide a valuable opportunity to observe the dynamics of intermarket competition in a limited context and unhampered by off-board trading restrictions, it recognized that the rule might also create certain problems.<sup>159</sup> For example, the rule would permit large retail brokerage houses, choosing to make over-the-counter markets in Rule 19c-3 securities, to execute public orders "in house" as principal without exposing these orders to the buying and selling influence of other market centers.<sup>160</sup> This in-house execution, or "internalization" might: (i) prevent customers from receiving the best price in their transactions; (ii) have an anti-competitive impact on traders who do not have access to large order flow; and (iii) draw volume away from the primary market centers ("fragment" the markets) thus decreasing the pricing efficiency of these markets.<sup>161</sup>

Although the Commission decided to adopt Rule 19c-3 in order to limit the anti-competitive effects of off-board trading restrictions, it cautioned that if "adverse effects" resulted from the internalization, the Commission would consider certain remedial actions. It might require that (i) off-board trading in Rule 19c-3 securities be conducted through an intermarket trading system that would expose such transactions to the orders flow of other markets; (ii) agency orders in Rule 19-3 securities be "held out" to other buyers and sellers for a specified minimum period prior to execution; and (iii) firms be prohibited from acting as

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<sup>157</sup> National securities exchanges have rules that limit the ability of members of an exchange to effect transactions as principals other than on an exchange in securities that are either listed or admitted to unlisted trading privileges on the member's exchange. See, e.g., NEW YORK STOCK EXCHANGE, INC. CONSTITUTION AND RULES, RULE 390 (CCH) ¶ 2390 (1981). As a practical matter these rules effectively prevent members from principal trading in listed securities in the over-the-counter markets. These "off-board trading restrictions" augment volume on the exchanges, thereby increasing exchange revenues and arguably improving the quality of exchange markets. At the same time, they obviously limit competition between exchange markets and over-the-counter markets in those securities that are traded both on and off exchanges ("third market" securities).

<sup>158</sup> In an experimental effort to remove burdens on intermarket market competition, the Commission adopted Rule 19c-3, precluding off-board trading restrictions on securities listed after April 26, 1979 (date on which Rule 19c-3 was proposed). Rule 19c-3 Adoption Release, note 156 *supra*. These restriction free securities are commonly referred to as Rule 19c-3 securities.

<sup>159</sup> Rule 19c-3 Adoption Release, note 156 *supra*, at 83,249.

<sup>160</sup> *Id.* at 83,252, 83,259.

<sup>161</sup> *Id.*

both a broker and a dealer in some or all Rule 19c-3 securities transactions.<sup>162</sup> These types of restrictions on off-board trading have come to be known as "anti-internalization rules."

When the Commission adopted Rule 19c-3, the existing intermarket trading system did not provide automated linkage, "interface" with the over-the-counter markets. According to the Commission, the Rule 19c-3 experiment could not become truly effective until a linkage was created between the intermarket trading system and a comparable system for the over-the-counter markets.<sup>163</sup> Demonstrating the urgency that the Commission attached to this matter, it requested a formal status report on this linkage from the parties involved by September 1, 1980,<sup>164</sup> less than three months after adoption of the rule.

The then six ITS participants, concerned about the possibility of order flow leaving the exchanges for internal execution by the large retail houses, were unilaterally opposed to the linkage.<sup>165</sup> The NASD, potentially a beneficiary of future losses by exchanges of order flow in Rule 19c-3 securities, embraced the linkage.<sup>166</sup> The Commission strongly favored the linkage and decided to forge ahead on the project. In February 1981, it proposed an order requiring an interface by September 30, 1981 of the ITS and the NASD's automated trading system.<sup>167</sup> Despite continued exchange opposition,<sup>168</sup> the Commission issued an order on April 21, 1981<sup>169</sup> requiring the linkage to be implemented by March 1, 1982, thus delaying the linkage five months beyond the date intended in its proposal release.<sup>170</sup> The exchanges

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<sup>162</sup> *Id.* at 83,255.

<sup>163</sup> *Id.* at 83,251. Such a system was being upgraded by the National Association of Securities Dealers at that time. More than a year later, the Rule 19c-3 Monitoring Report also suggested that the linkage would benefit the rule 19c-3 experiment. RULE 19c-3 MONITORING REPORT, note 118 *supra*, at 41.

<sup>164</sup> Rule 19c-3 Adoption Release, note 156 *supra*, at 83,251-52.

<sup>165</sup> In September 1980, the AMEX, BSE, NYSE, PHLX and PSE all sent identical letters to the Commission opposing the linkage. The MSE sent a separate letter of opposition. Securities Exchange Act Rel. No. 17516 (Feb. 5, 1981), 46 Fed. Reg. 12,379, 12,381-82 (Feb. 13, 1981), 21 SEC DOCKET 1519. (Feb. 17, 1981) [hereafter Linkage Proposal Release].

<sup>166</sup> The NASD sent a letter in September 1980 to the Commission reaffirming its support for the linkage. 46 Fed. Reg. at 12,382.

<sup>167</sup> *Id.* at 12,379.

<sup>168</sup> Securities Exchange Act Rel. No. 17744 (Apr. 21, 1981), [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268, 84,275, 22 SEC DOCKET 845 (May 5, 1981) [hereafter Linkage Adoption Release].

<sup>169</sup> *Id.*

<sup>170</sup> This date was viewed as an "outside date" to fully accommodate needs for implementation. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,269.

maintained their opposition, arguing in part that linkage should be preceded by anti-internalization rules. They feared that the linkage would encourage additional OTC market makers to begin trading "19c-3 securities" and to begin internalizing order flow.<sup>171</sup> In addition, the NYSE raised the concern that by creating the linkage before addressing the problems of internalization, the OTC representatives would lose any incentive to work with the exchanges in resolving the internalization issues.<sup>172</sup>

Thus, by the time the Commission had decided to move forward on what it viewed as a major regulatory goal — linking the exchanges and the over-the-counter markets — it had been made aware of significant industry concerns with linkage in the absence of rules dealing with problems of internalization. It also knew that the exchanges perceived their self-interest to be inconsistent with the linkage goal and the self-interests of NASD. The Commission, at that point, might not have been certain that internalization would be a problem;<sup>173</sup> but it certainly knew that the ITS participants thought otherwise.<sup>174</sup> The Commission was eager to have the industry move forward on the linkage without delay. It had already delayed the desired implementation date by five months<sup>175</sup> and it considered the continued absence of a linkage as "frustrating progress toward achievement of important objectives of the [Securities Exchange] Act."<sup>176</sup>

When the Commission ordered the linkage of the NASD trading system and ITS, it could have also assumed responsibility for the imple-

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<sup>171</sup> *Id.* at 84,275. The NYSE argued that "the one fundamental rule which must be required to precede commencement of any test linkage in order to preserve the quality of the nation's securities market for listed securities and the basic fairness of that market is a rule which appropriately addresses 'internalization . . .'" Letter from J.E. Buck, Secretary of the NYSE, to George A. Fitzsimmons, Secretary of the SEC (Mar. 13, 1981), SEC File No. 4-208 at 4-5. The Commission did not agree that linkage would exacerbate internalization. Linkage Adoption Release, note 168 *supra*, at 84,275.

<sup>172</sup> Linkage Adoption Release, note 168 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,272-73. Letter from J.E. Buck, Secretary of the NYSE, to George A. Fitzsimmons, Secretary of the SEC (Mar. 13, 1981), SEC File No., 4-208.

<sup>173</sup> The Commission did not agree that internalization was a problem. Linkage Adoption Release, note 168 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,277. This seems somewhat curious in light of the Commission's concurrent reaffirmation of "its support of industry efforts to address internalization concerns promptly." *Id.* at 84,278.

<sup>174</sup> See text accompanying notes 170-71 *supra*.

<sup>175</sup> See text accompanying note 170 *supra*.

<sup>176</sup> Linkage Adoption Release, note 168 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,274.



mentation of an anti-internalization rule. The same statutory authority upon which the Commission relied to require linkage, would have been sufficient authority to allow the Commission to respond to the internalization problem.<sup>177</sup> Assuming responsibility for responding to internalization would not have required the Commission to act immediately in implementing an anti-internalization provision.<sup>178</sup> At the time of the issuance of the linkage order, the Commission felt that internalization concerns could not be properly evaluated or addressed until after the linkage was effected.<sup>179</sup> The Commission could have indicated that it would assume ultimate responsibility for resolving internalization problems, if they appeared, and could still have refrained from attempting resolution of the problems until the dimensions of the problems became more clearly defined.<sup>180</sup>

Instead of assuming immediate or eventual regulatory responsibility for resolving potential internalization problems, the Commission chose to allocate responsibility for this issue to the SROs. Twice in the Linkage Adoption Release, the Commission reaffirmed its support of an industry effort to "address internalization concerns *promptly*."<sup>181</sup> Although the SROs might gain psychological benefits by self-resolution of the internalization problem,<sup>182</sup> the guidelines for allocating regulatory responsibility would suggest that the SEC should have sought to resolve the question of anti-internalization rules itself.

Compelling the SROs to resolve the internalization rule issue would arguably result in one of two courses of behavior for the exchanges. The exchange might have to expend resources internally to counter membership self-interest and achieve a resolution of the internalization

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<sup>177</sup> The Commission relied on §§ 2, 3, 5, 10, 11A, 15A, 17 and 23 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78b, 78c, 78f, 78j, 78l, 78l-1, 78r, 78x (1976) for authority to order the linkage. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,283.

<sup>178</sup> The Commission might have assumed responsibility for the matter and then made a determination, after a satisfactory study, that an anti-internalization rule should not be adopted. This nonaction would be fully consistent with an assumption of regulatory responsibility.

<sup>179</sup> Linkage Adoption Release, note 168 *supra*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,275.

<sup>180</sup> The Commission had some fairly developed notions of how to approach potential internalization problems. See note 162 and accompanying text *supra*.

<sup>181</sup> Linkage Adoption Release, note 168 *supra*, [Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 84,268 at 84,275, 84,278 (emphasis added). This call for prompt consideration by the SROs suggested that an internalization resolution did not need to be delayed until after linkage.

<sup>182</sup> See text accompanying notes 82-83 *supra*.

problem that would be compatible with the self-interests of the NASD. Alternatively, the exchanges might resolve the internalization problem in a manner consistent with their self-interests and then expend resources in negotiations with the NASD, which organization would be motivated by competing self-interests. The latter course would probably lead to inaction and delay on the internalization issue and the expenditure of resources needed to counter competing SROs' self-interests.

The Commission would not be subject to these self-interests. In addition, the Commission had a fairly sophisticated sense of what it wanted in an anti-internalization rule when it ordered the adoption of Rule 19c-3<sup>183</sup> and possibly did not need the technical expertise of the SROs in developing such a rule. To the extent that the Commission needed refinements of its ideas, it could have either sought comments on its proposals<sup>184</sup> or employed its indirect authority and required the exchanges to propose rules that would accommodate certain specified Commission goals on internalization. As events developed, a number of problems arose with the handling of the anti-internalization question by the SROs. The continued disagreement among the SROs regarding an anti-internalization rule caused delays in the fulfillment of the linkage. The Commission found itself "troubled" that the concerns of the ITS participants and the NASD over internalization matters were hampering progress toward agreement on certain operational aspects of the linkage not immediately related to internalization.<sup>185</sup> These operational matters needed to be resolved before linkage could be effected. Eleven months after the linkage was ordered, a securities industry newsletter reported that "[a]lmost no progress on substantive issues dividing the parties has been made since the Commission ordered the link

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<sup>183</sup> See text accompanying note 162 *supra*.

<sup>184</sup> Ultimately, the Commission did seek public comment on anti-internalization proposals. Securities Exchange Act Rel. No. 18738 (May 18, 1982), 25 SEC DOCKET 484 (May 25, 1982) [hereafter Order Exposure Rule Release]. These proposals were developed by the NYSE and the Securities Industry Association (the SIA) respectively.

The Commission can be extremely effective in soliciting public comment. In response to its request for comments on the proposed order exposure rules, the Commission received over 450 comment letters. Securities Exchange Act Rel. No. 19372 (Dec. 23, 1982). This ability of the Commission to elicit public comment might represent, in some situations, another reason for Commission assumption of regulatory responsibility. The Commission refined its proposals and again sought public comment on the revisions, partially because of the large response to the Commission's initial request for comments on its proposed order exposure rules. *Id.*

<sup>185</sup> Securities Exchange Act Rel. No. 18536 (Mar. 4, 1982), 24 SEC DOCKET 1237, 1242 (Mar. 16, 1982) [hereafter First Delaying Release].

last April [1981]."<sup>186</sup> These disputes compelled the Commission to delay the linkage again from March 1, 1982, until May 1, 1982.<sup>187</sup>

This delay proved inadequate and immediately before the rescheduled implementation date, the press reported that "[c]ontinuing industry squabbles likely will force another delay in the planned electronic trading link between stock exchanges and the over-the-counter market."<sup>188</sup> One week later, as an after-the-fact announcement, the Commission again determined it was necessary to delay implementing this critical national market system component.<sup>189</sup>

The inefficiencies associated with the implementation of the linkage were not limited to delays. The reluctance of the SROs to effectively resolve the problems they had with the linkage ultimately compelled the Commission to assume responsibility for these matters and to initiate its own resolutions. Thus, in March of 1982, at the time of the first delay of the linkage order, the Commission found it necessary to propose its own facilitating amendments to the ITS Plan<sup>190</sup> in order to promote the linkage.<sup>191</sup> Although the Commission's proposals reflected many of the ideas developed by the ITS participants,<sup>192</sup> the Commission's assumption of initiation authority at this point ultimately required it to duplicate many of the efforts and thought processes in which the SROs had already engaged. This duplication of effort wasted regulatory resources.

Even the central question of internalization, responsibility for which the Commission squarely placed with the SROs, was ultimately assumed by the Commission,<sup>193</sup> again duplicating earlier efforts. Not

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<sup>186</sup> *I-T-S Link Delayed with New Internalization Rule in the Works*, Sec. Week, Mar. 1, 1982, at 1.

<sup>187</sup> First Delaying Release, note 185 *supra*.

<sup>188</sup> Wall St. J., Apr. 29, 1982, at 25, col. 1.

<sup>189</sup> Securities Exchange Act Rel. No. 18712 (May 6, 1982), 25 SEC DOCKET 360 (May 18, 1982) [hereafter Second Delaying Release].

<sup>190</sup> The ITS Plan is the set of rules governing the operation of ITS. It was filed with the Commission by the participating exchanges in March 1978. Plan Submitted to Securities and Exchange Commission for the Purpose of Creating and Operating an Intermarket Communication Linkage Pursuant to Section 11A(a)(3)(B) of the Securities Exchange Act of 1934, SEC File No. 4-208 (1978).

<sup>191</sup> First Delaying Release, note 185 *supra*. The principal amendments that the SEC proposed dealt with (i) requirements that OTC market makers maintain markets during periods of adverse market activity; (ii) order entry techniques into the linked system by OTC market makers; and (iii) methods of reporting OTC trades. *Id.* 24 SEC DOCKET at 1083-86. The Commission's proposals were adopted in Securities Exchange Act Rel. No. 18713 (May 6, 1982), 25 SEC DOCKET 362 (May 18, 1982).

<sup>192</sup> First Delaying Release, note 185 *supra*, 24 SEC DOCKET at 1083.

<sup>193</sup> Order Exposure Rule Release, note 184 *supra*.

merely were alternative order exposure rules proposed as a means of responding to internalization, but the entire question of the advisability of adopting any order exposure rule was proposed for examination by the Commission.<sup>194</sup>

The Commission did not necessarily view the efforts of the securities industry as wasted. It praised the New York Stock Exchange and the Securities Industry Association for developing general principles regarding possible order exposure rules.<sup>195</sup> The Commission stated that it was basing its own two rule proposals on these principles and that it was now time for the proposals to be given full public discussion.<sup>196</sup>

As a practical matter the two proposals presented by the Commission for public comment do not differ dramatically in substance from those that the Commission mentioned as possible courses of action two years earlier when it adopted Rule 19c-3.<sup>197</sup> In addition, if the Commission was now assuming responsibility for the internalization problem because it thought that the securities industry proposals required public discussion, that discussion could have also been achieved by the SROs filing rule proposals, which under Section 19(b)(1) would have been subject to a period of public comment.<sup>198</sup>

The Commission's action can be explained by recognizing that the conflicts of self-interest between some of the SROs and Commission goals were of such dimension that they impeded fulfillment of national market system objectives. Only the Commission could operate without

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<sup>194</sup> *Id.* This call for a total examination of the wisdom of anti-internalization rules raised initially the spectre that the year-long SRO efforts to arrive at a satisfactory anti-internalization rule would have been for naught. In December, 1982, the Commission repropose a refined version of the order exposure rule containing elements of both of the earlier alternatives. Securities Exchange Release No. 19372 (Dec. 23, 1982). As of March, 1983, the Commission has not made a decision as to whether there will be an order exposure rule, or what might be the nature of such a rule.

<sup>195</sup> Order Exposure Rule Release, note 184 *supra*, 25 SEC DOCKET at 361.

<sup>196</sup> *Id.*

<sup>197</sup> See text accompanying note 163 *supra*. The most significant difference between the Commission's earlier suggestions and the proposals it made based upon the work of the SROs and the securities industry is that under the latter proposals, when the customer orders are held out in the intermarket trading systems, they would be held out at a price  $\frac{1}{8}$  of a point better than the price at which the Rule 19c-3 securities market maker was proposing to execute as principal. To prevent the public customer from losing the benefit of the price at which the market maker was initially intending to execute, the market maker would have to guarantee the execution at least at the proposed price (i.e., he would "stop the order"). Order Exposure Rule Release, note 184 *supra*, 25 SEC DOCKET at 361-62. The central concept of holding out the order to the general buying public was incorporated in the original Rule 19c-3 Adoption Release.

<sup>198</sup> Securities Exchange Act of 1934, § 19(b)(1), 15 U.S.C. § 78s(b)(1) (1976).

undue influence from these self-interests.<sup>199</sup> Had the Commission recognized the implication of that conflict a year earlier, it might have prevented the inefficiencies of delayed achievement of national market system goals and duplicative regulatory activities.<sup>200</sup>

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<sup>199</sup> Shortly before the Commission made its proposal, the head of the SIA task force on anti-internalization rules was quoted as saying that the Commission itself would have to resolve the dispute over internalization, if it wanted the matter quickly resolved. Wall St. J., Apr. 29, 1982, at 25, col. 1.

<sup>200</sup> The Commission, in its defense, explained that the period during which the SROs had initiating responsibility for the order exposure rules was productive because the ideas generated by the SROs and by the SIA needed time to percolate about the industry. Referring to the SIA's contribution during this period, the SEC said "[t]he SIA's work constituted a step forward in the process of articulating practical methods of addressing generalized order exposure concerns." Order Exposure Rule Release, note 184 *supra*, 25 SEC DOCKET at 361. The Commission characterized the NYSE's efforts as providing "an important and concrete proposal addressing one aspect of [the internalization] issue and [they] serve a useful function in focusing industry attention on this issue." *Id.* However, the Commission felt the SEC should complete the process. The Commission appeared to concur with the NYSE's position that "because of the complexity of the issues and the differing interests of sectors of the industry, further progress in addressing internalization concerns requires the active participation of the Commission." *Id.* If the Commission's analysis of events is accurate, then the allocation of regulatory responsibility made by the Commission was not as inefficient as would otherwise appear. It is possible that the industry indeed needed more time to work on the proposals before they were ready for the Commission's final efforts. This analysis would be consistent with the qualifications of the guidelines found in note 84 and accompanying text *supra*. The inconsistency with this analysis is that the internalization issue was not thrust upon the securities industry with the adoption of the linkage order. The problems of internalization were very much in the forefront of industry thinking as far back as 1975, when Congress directed the Commission to remove all off-board trading restrictions. Securities Exchange Act of 1934, § 11A(c)(4), 15 U.S.C. § 78k-1(c)(4) (1976). In response to the congressional directive, the Commission called for hearings to discuss several proposals for elementary off-board trading restrictions. Securities Exchange Act Rel. No. 11628 (Sept. 2, 1975), 40 Fed. Reg. 41,808. Some of these proposals suggested the possibility of eliminating off-board trading restrictions for both principal and agency transactions. 40 Fed. Reg. 41,808, at 41,816. Thus in 1975, the spectre of internalization problems was raised. As it turned out, Rule 19c-1, which the Commission adopted in 1975, eliminated off-board trading restrictions only for agency trades. Securities Exchange Act Rel. No. 11942 (Dec. 19, 1975), 41 Fed. Reg. 45,071, 8 SEC DOCKET 756 (Jan. 5, 1976). Again, in 1977, internalization was an issue in the securities industry when the Commission proposed Rule 19c-2 which would have had the effect of eliminating off-board trading restrictions for principal transactions. Securities Exchange Act Rel. No. 13662 (June 23, 1977), 42 Fed. Reg. 33,510, 12 SEC DOCKET 947 (July 5, 1977). At this point, the Commission went so far as to provide specific proposals for the industry to consider to minimize internalization. 42 Fed. Reg. 33,525.

If the industry did not develop meaningful approaches for minimizing internalization

## V. SUMMARY OF CASE STUDIES

It should be noted that in one instance the manner in which regulatory responsibility was in fact allocated was largely consistent with what the criteria would direct. In the other two instances, the actual allocation was inconsistent with the dictates of the guidelines. It would be premature to conclude that in the two instances of inconsistent allocation the wrong regulatory problem solving approach was employed. Unique factors, not accounted for by the criteria, might have necessitated the specific approach taken at the time. In those instances in which the allocation of responsibility was inconsistent with the guidelines, however, certain problems later developed in the regulatory process. In one instance there was an excessive delay in achieving a regulatory resolution which affected other regulatory projects. In the other case, the regulatory resolution did not conform to certain other regulatory goals, and in part, prevented the attainment of these other goals. In both instances, the problems which later arose in the regulatory process might be linked to the manner in which regulatory responsibilities initially were allocated.

## CONCLUSION

A system of regulation of our national securities markets has developed wherein numerous elements of authority are shared by two institutions — the industry, the SROs and the governmental oversight body, the SEC. There has not, however, been a corresponding development of precepts to indicate which of these two institutions should assume authority to initiate the resolution of matters of significant regulatory concern.

On the basis of specific efficiency concerns, this article has developed guidelines that can be employed by the SEC and the SROs to suggest which regulatory body should attempt to resolve which issues. When the guidelines indicate that responsibility should be assumed by the SEC, they can be further employed to suggest which of its several types of regulatory authority the SEC should employ.

The approach developed in this article to assist in the efficient alloca-

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between 1975 and 1981, it was unrealistic of the Commission to anticipate productive contributions in 1981. The Commission concluded, however, that the exchanges did make meaningful contributions. In light of earlier discussions suggesting that the industry indeed did not make significant progress on internalization in 1981 and early 1982, *see* notes 186-97 and accompanying text *supra*, it is possible that the Commission's flattering assessments of the securities industry's contributions may have been made for political reasons.

tion of regulatory responsibilities within a specific self-regulatory scheme — that of the securities markets — has ramifications for broader self-regulatory questions. Similar criteria can be developed to resolve whether an industry should regulate itself at all or be regulated by the government. As with the question explored in this article, the answers to these related issues might not be uniform, but, rather, might vary depending upon the nature of the specific problem which the regulation would address.